

Employee Benefits Hot Sheet -- **Breaking Developments in Employee Benefit Law**

05.19.2005

Relief for Procrastinators --IRS Relaxes Cafeteria Plan "Use-it-or-Lose-it" Rule

After years of warning flexible spending account ("FSA") participants about the "use-it-or-lose-it" rule, the IRS has issued a notice that provides a very significant exception to the rule and allows FSA participants to receive reimbursement for expenses INCURRED up to 2 1/2 months after the end of the plan year. Although most FSAs already have a grace period for submission of expenses after the end of the plan year, the expense is reimbursable only if it was incurred during the preceding plan year. Notice 2005-42 expands this rule by allowing reimbursement of expenses even if they are incurred during the first 2 1/2 months of the subsequent plan year.

Here's how it works.

A cafeteria plan document may, at the employer's option, be amended to provide for a grace period immediately following the end of each plan year. The grace period must apply to all participants in the cafeteria plan. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions remaining unused at the end of the immediately preceding plan year. The grace period must not extend beyond the 15th day of the third calendar month after the end of the immediately preceding plan year. For calendar year plans, this would be March 15 (2 1/2 months after December 31). If a cafeteria plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year. The effect of the grace period is that the participant may have as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are "forfeited" under the "use-it-or-lose-it" rule.

This grace period applies equally to health care expenses and dependent care expenses. However, it does not change the rule that contributions to the health FSA cannot be used to reimburse dependent care expenses, and contributions to the dependent care FSA cannot be used to reimburse health care expenses.

While this liberalization is likely to help procrastinators, it does present some administrative challenges. These should arise primarily for claims administrators. Before adopting this grace period rule, employers will want to coordinate with the FSA claims administrator to make sure they are able to administer the grace period (e.g., by applying post-plan year expenses first to the carry-over account and then to the current-year account). Also, to apply this rule for the plan year

ending December 31, 2005, a plan amendment must be adopted no later than December 31, 2005. Finally, it will be important to communicate the new rule to participants, emphasizing that the 2 1/2 month grace period is a firm deadline.

Lane Powell's employee benefits lawyers are available to assist you in implementing this new rule.

For more information, please contact the Employee Benefits Group at Lane Powell:

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