Benefits ASAP

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IRS Allows Employers to Provide Grace Period For Flexible Spending Accounts

By Steven J. Friedman and Michelle I. Pretlow

On May 18, 2005, the Internal Revenue Service issued Notice 2005-42 which permits employers to adopt a grace period of up to 2½ months after a plan year for participants in flexible spending accounts ("FSAs") to use FSA funds which were unused during that plan year. This is a welcome change for FSA participants.

Background

A "cafeteria plan" is a plan under which participants may choose between cash and non-cash benefits offered under the plan each plan year pursuant to Internal Revenue Code Section 125. One benefit which may be offered under a cafeteria plan is a "flexible spending account" or FSA.

An FSA allows participants to convert taxable income into tax-free reimbursements of otherwise unreimbursed eligible expenses, such as medical, dental or vision care expenses or dependent care expenses. A cardinal rule governing cafeteria plans under Section 125 is that participants may not defer the receipt of income by allowing contributions made in one plan year to be used in a subsequent plan year. Under an FSA, this rule has manifested itself in the requirement that reimbursable expenses must be incurred by the end of the plan year for which compensation has been deferred. Compensation deferrals in excess of reimbursable expenses for that plan year are forfeited. This requirement, commonly known as the "use-it-or-lose-it" rule, has a clear deterrent effect upon would-be FSA Plan participants as it can be difficult to predict the amount of unreimbursed health expenses for a plan year. Accordingly, there has been some pressure on the government to liberalize the "use it or lose it" rule to encourage greater use of FSAs.

Notice 2005-42

The IRS provided this liberalization in Notice 2005-42 which permits employers to extend the date for which medical claims can be incurred for a plan year to any time up to the fifteenth day of the third month after the end of the plan year — March 15 for calendar year plans. The IRS' reasoning behind this new rule is that other areas of tax law do not treat amounts paid within 2½ months after the calendar year as deferred compensation and that this principle may be applied to FSAs.

In order to implement this new provision, employers which sponsor FSAs must:

1. Amend the plan document to provide for a grace period not to exceed 2½ months;
2. Apply the grace period to all participants in the plan;
3. Forfeit any unused benefits or contributions that exceed the amount of expenses incurred during the claims period (which now includes the plan year plus the grace period) at the end of the grace period.

This new extension may be adopted for the current plan year so long as an amendment is made prior to the end of the plan year (therefore, to implement currently for a calendar year plan an amendment must be made by December 31, 2005 for a calendar year plan).

Employers are not required to adopt a grace period. Before making this change (which clearly will be desired by employees) employers should consider that enhanced employee communications will be required the year of the change. Also, the adoption of a grace period may, in fact, create some confusion in the minds of employees who have gotten used to a 12-month FSA period as to how much to defer into the FSA account. Lastly, employers should keep in mind that a longer reimbursement period may encourage employees to deposit more in their FSAs. For health care reimbursement FSAs, this may put employers at greater risk that an employee will leave employment before fully funding the FSA but having the legal right to draw on the FSA as though it were fully funded. An employee who elects to contribute $2,400 to a health care reimbursement FSA will fund that account for $200 per month, but may request the entire $2,400 at any time during the year provided the participant has incurred $2,400 in qualifying expenses. Therefore the participant could contribute $200, receive $2,400 as a reimbursement and then terminate employment, leaving the employer with a $2,200 shortfall. As such, employers should think through the possible consequences of adopting a grace period prior to taking action to do so.

For further assistance, please consult one of our attorneys in the Employee Benefits Practice Group. We are available to assist you in preparing amendments to your plan to incorporate the new grace period.

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