CAFETERIA PLAN "USE IT OR LOSE IT RULE" MAY BE MODIFIED TO ALLOW FOR A 2-1/2 MONTH GRACE PERIOD

In a surprise move, the IRS has announced employers may elect to modify the cafeteria-plan "use it or lose it" rule to allow for a 2-1/2 month grace period. More specifically, if their cafeteria plan is amended, participants with a balance remaining at the end of the plan year will be able to use it for qualifying expenses within a 2-1/2 month grace period following the end of the plan year.

- **Background**

  Cafeteria plans (also known as flexible benefit plans or flexible benefit arrangements) allow employees to pay for qualified benefits with pre-tax dollars. Qualified benefits include certain employer-provided accident and health plans excludable, certain group-term life insurance, dependent care assistance programs and adoption assistance programs. A cafeteria plan can't defer the receipt of compensation or operate in a way which enables participants to defer compensation by, for example, allowing participants to use contributions for one plan year to buy a benefit which will be provided in a subsequent plan year. This rule is commonly referred to as the "use-it-or-lose-it" rule, requiring unused contributions or benefits remaining at the end of the plan year be forfeited.

  Consistent with rules in other tax areas which permit a limited grace period (e.g., the rule which does not tag as deferred compensation payments made by employers to employees within 2-1/2 months after the close of the tax year), IRS says it is appropriate to modify the current rules to permit a 2-1/2 month grace period after the end of the plan year during which unused benefits or contributions may be used.

- **New election to use 2-1/2 month rule**

  The Notice permits (but does not require) an employer to amend its cafeteria plan to give all participants a grace period lasting no longer than 2-1/2 months immediately following the end of each plan year. 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. If the amendment is made, 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.

- **Net effect**

  A 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.

  During the grace period, unused benefits or contributions can't be cashed-out or converted to any other taxable or nontaxable benefit. Unused amounts relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred for that particular qualified benefit. For example, unused amounts in a health flexible spending arrangement can't be used to pay or reimburse dependent care or other expenses incurred during the grace period. The Notice says, as under current practice, employers may continue to provide a "run-out" period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

An employer may adopt a grace period as authorized in the Notice for the current cafeteria plan year, and subsequent cafeteria plan years, by amending the plan document before the end of the current plan year.

Observation: Thus, if a cafeteria plan is on the calendar year, the new election would apply for the first time for the 2005 plan year, if the plan document is modified before the end of 2005.

Illustration: ABC Corp. maintains a cafeteria plan with a year ending on December 31, 2005. It amends the plan before the end of 2005 to allow all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period ends on the fifteenth day of the third calendar month after the end of the plan year (March 15, 2006 for the plan year ending December 31, 2005). Xavier, an ABC employee, timely elected a salary reduction of $1,000 for a health FSA for the plan year ending December 31, 2005, and $1,500 for the plan year ending December 31, 2006. As of December 31, 2005, Xavier has $200 remaining unused in his health FSA. During the grace period from January1, through March 15, 2006, he incurs $300 of unreimbursed medical expenses. The unused $200 from the plan year ending December 31, 2005, is applied to pay or reimburse $200 of Xavier's $300 of medical expenses incurred during the grace period. Thus, on March 16, 2006, he has no unused benefits or contributions remaining for the 2005 plan year. The remaining $100 of medical expenses incurred between January1, and March15, 2006 is paid or reimbursed from Xavier's health FSA for the 2006 plan year. On March 16, 2006, Xavier has $1,400 remaining in his health FSA for the 2006 plan year.

- **More formal guidance to come**

IRS says it will modify existing proposed regulations to reflect the position of the Notice.