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ERISA and Employee Benefits Update - IRS Relaxes the Cafeteria Plan "Use-It-or-Lose-It" Rule

By Erwin Kratz

On May 18, 2005, the Internal Revenue Service swept away years of strict adherence to the "use-it-or-lose-it" rule for cafeteria plans, the welfare benefit plans that allow employees to select and pay for a variety of welfare benefits on a pre-tax basis typically by payroll deduction. Cafeteria plans permit employee participants to choose among two or more benefits consisting of cash and qualified benefits. Typical qualified benefits include flexible spending accounts (FSAs) to reimburse medical expenses not otherwise covered under accident and health plans, dependent care assistance programs, and adoption assistance programs.

Under the "use-it-or-lose-it" rule, contributions or payroll deductions remaining unused after the end of the plan year, because the employee did not have sufficient claims for benefits during the plan year, must be forfeited.

Notice 2005-42 has softened the burden of this longstanding rule by allowing employers to modify their cafeteria plans to give all participants a grace period, of up to 2 ½ months immediately following the end of each plan year, during which unused contributions or payroll deductions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified expenses incurred during the grace period.

The New Optional 2 ½-Month Grace Period

Employers now have the option, though they are not required, to amend their cafeteria plans to provide for up to a 2 ½-month grace period immediately following the end of each plan year as an exception to the "use-it-or-lose-it" rule. The grace period must apply to all participants in the cafeteria plan.

If an employer amends its cafeteria plan document and adopts a grace period, expenses for qualified benefits incurred during the grace period may be paid or reimbursed from contributions or payroll deductions remaining unused at the end of the immediately preceding plan year, effectively giving a participant as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use contributions or payroll deductions for a plan year before those amounts are forfeited under the "use-it-or-lose-it" rule.

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. Employers who amend their plans to adopt a grace period under the new guidance should extend the run-out period as well.

Practical Considerations

There are numerous practical considerations to take into account before deciding to add a grace period to your cafeteria plan.

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- **First**, and most significant, an employer who is considering adopting the grace period should only do so after confirming that the entity it uses to process cafeteria plan claims has completed the appropriate review of its claims processing systems and implemented the programming and process changes necessary to administer a grace period.

While on the surface the change seems simple, at a practical level the necessary systems changes will take time, particularly for plans using debit cards. Many providers are targeting August 1 implementation dates, which may require plans with June 30 or July 31, 2005 plan year ends to delay implementation of the grace period until the plan year that will end on June 30 or July 31, 2006.

- **Second**, and significant for employers who are offering a High Deductible Health Plan (HDHP) with a Health Savings Account (HSA), the adoption of an FSA grace period may disqualify its participating employees from contributing to an HSA for the duration of the grace period because an FSA that reimburses for broad range of medical expenses constitutes impermissible "other health coverage" which precludes HSA contributions.

A person is eligible to contribute to an HSA in any month in which he or she is covered by an HDHP. An individual cannot contribute to an HSA, however, if he or she is simultaneously covered under a cafeteria plan FSA that provides reimbursement for medical expenses. It is possible that an FSA's reimbursement of medical claims incurred in a grace period during which a participant is simultaneously covered by an HDHP will count as impermissible "other coverage" even though the funds to pay the reimbursement come from a prior year, thereby disqualifying the employee from contributing to an HSA during the grace period.

To avoid this problem, employers with HDHPs and HSAs should consider: (1) amending the FSA option under their cafeteria plans to limit benefits to permissible benefits such as vision and dental reimbursements during the grace period if an FSA participant also participates in an HDHP and HSA (this change should already have been made to the cafeteria plan for the plan year if an employer offers an HDHP with an HSA) **or** (2) amending the FSA option to waive the grace period altogether for participants who are HSA participants during the grace period.

- **Third**, employers deciding to adopt a grace period should carefully lay out employee communications as soon as possible after making the decision, including: (1) the addition and timing of the grace period; (2) specific instructions on how a claim can be made for the grace period; and (3) the point in time when service providers will be ready to process claims incurred in a grace period against a prior year's contributions or payroll deductions.

- **Fourth**, the relaxation of the "use-it-or-lose-it" rule does not change any other rules. Cafeteria plans still may not permit unused contributions or payroll deductions to be cashed-out or converted to any other taxable or nontaxable benefit during the grace period. In other words, unused contributions or payroll deductions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to that particular qualified benefit. For example, unused amounts originally contributed to pay or reimburse medical expenses in a health flexible spending arrangement (FSA) may not be used to pay or reimburse dependent care or other expenses incurred during the grace period.

Conclusion

Employers wishing to adopt a grace period for the current cafeteria plan year (and subsequent cafeteria plan years) can do so by amending the cafeteria plan document before the end of the current plan year. If you would like assistance with adopting and implementing the new cafeteria plan grace period, including a review of documents prepared by service providers, or if you have any questions regarding your employee benefit programs, please contact Erwin Kratz, Cindy Shupe, or David Heap.

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