

FSA MAY REIMBURSE EXPENSES INCURRED AFTER YEAR END

The IRS just issued Notice 2005-42, which will reduce the impact of the “use-it-or-lose it rule” by allowing employers to give cafeteria plan participants an additional 2-1/2 months after the close of a plan year to use contributions or benefits that were unused during that plan year. Importantly, this optional grace period may be implemented for the current plan year.

BACKGROUND

Under Treasury regulations, a cafeteria plan may not operate so as to allow participants to defer compensation – e.g., by permitting participants to use contributions for one plan year to purchase a benefit that will be provided in a subsequent plan year. This rule, commonly referred to as the “use-it-or-lose-it” rule, requires that contributions or benefits that are unused at the end of the plan year be “forfeited.”

For other tax purposes, compensation for services paid within 2-1/2 months of the close of the year following the year in which the services being compensated were performed is not treated as deferred compensation. In Notice 2005-42, the IRS has extended this principle to cafeteria plans.

NOTICE 2005-42

Notice 2005-42 permits employers to give cafeteria plan participants an additional “grace period” of up to 2-1/2 months in which to use contributions or benefits that were not used by the end of the plan year. This means that a participant in a calendar year cafeteria plan who had \$200 in unused salary reductions in a health FSA on December 31st would not forfeit that \$200 but could apply that amount to health FSA expenses incurred on or before March 15th of the following year. Only amounts in the health FSA that remain unused after March 15th would be forfeited.

Notice 2005-42 stipulates that general cafeteria plan principles continue to apply during the grace period, i.e. –

- The grace period must be made available to all cafeteria plan participants.
- Unused benefits or contributions may not be cashed out or converted to any other taxable or nontaxable benefit.
- Unused benefits or contributions relating to one benefit may only be used to pay for or reimburse expenses incurred with respect to that particular benefit. For example, unused amounts in a health FSA could not be used for dependent care expenses incurred during the grace period.

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.

Implementation of the grace period is not required. An employer that wants to provide a grace period for the 2005 plan year may do so by amending its cafeteria plan document by December 31, 2005. Employers that wish to do so must also consider how they will coordinate this grace period with other health plans and contributions for 2006.

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