

Special Edition**FSA “Use-It or Lose-It” Rule May Be Modified To Allow
For A 2-1 / 2 Month Rollover Period To Incur Expenses****IRS Says Rollover Permitted If Employer Makes The Election Before Plan Year Ends**

In a surprise move, the IRS announced on May 18, 2005 that employers may elect to modify their cafeteria plan’s “use it or lose it” rule for flexible spending accounts (FSAs) to allow for a 2-1/2 month rollover period. If a cafeteria plan is amended, participants with a balance remaining in their FSAs at the end of any plan year will be able to use the balance for qualifying expenses within a 2-1/2 month grace period in the following plan year according to IRS Notice 2005-42.

There have been proposals in Congress to liberalize the “use it or lose it” rule for several years, including a \$500 rollover provision in the Medicare Prescription Drug, Improvement and Modernization Act of 2003 signed by President Bush on December 8, 2003 that did not make the final bill. As recently as January 2005, Treasury Secretary John Snow rejected a request by Senate Finance Committee Chairman Charles Grassley (R) to modify the “use-it or lose-it” rule. Critics have long argued that the rule discourages FSA participation.

Background

Cafeteria plans (also known as flexible benefit plans, flexible benefit arrangements and flexible spending account plans) allow employees to pay for qualified benefits with pre-tax dollars. Qualified benefits include employer-provided accident and health plans under Code Sec. 106 and Code Sec. 105(b), group-term life insurance under Code Sec. 79, dependent care assistance programs under Code Sec. 129, and adoption assistance programs under Code Sec. 137. A cafeteria plan cannot defer the receipt of compensation or operate in a way that enables participants to defer compensation. For example, enabling participants to use contributions from one plan year to buy a benefit that will be provided in a subsequent plan year. This rule is commonly referred to as the “use-it-or-lose-it” rule, requiring that unused contributions remaining at the end of the plan year be forfeited.

Election To Use The 2-1 / 2 Month Rule

Notice 2005-42 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 to incur expenses in a new plan year. Expenses for qualified benefits incurred during the grace period may be reimbursed from contributions remaining unused at the end of the preceding plan year. If the amendment is made, prior year funds are used first until exhausted and then new plan year contributions are used. The 2-1/2 month rule applies to both health and dependent care FSAs.

Application of the Rule

The 2-1/2 month rule applies for any plan year ending in 2005, not just calendar year plans.

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 2-1/2 month grace period) to use their contributions for a plan year before those amounts are forfeited under the “use-it-or-lose-it” rule.

Employer Pre-Funding Health FSA

Employer pre-funding is not required. That’s because the employee would have fully contributed to their health care FSA by plan year end.

Impact On Standard 90 Day Claims Run-Out Period

The new 2-1/2 month rule does not change the traditional run-out period of 90 days following the end of a plan year for participants to submit claims for expenses incurred in the prior year. The new 2-1/2 month rule is intended to eliminate forfeitures so participants can spend their unused contributions. However, it is possible for employers to elect a longer run-out period than 90 days after the end of the plan year since carriers may not have processed claims or sent out Explanation of Benefit (EOB) Statements.

At TAI, we suggest a “grace” period to submit year-end claims longer than 90 days due to the new 2-1/2 month extension to incur claims using prior year’s funds, perhaps as long as 6 months from any plan year end.

Additional Information

During the grace period, unused benefits or contributions cannot 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 FSA may not be used to reimburse dependent care expenses during the grace period.

Implementing The 2-1/2 Month Rollover - Employers Must Adopt New Rule In Writing

An employer may adopt the grace period as authorized in Notice 2005-42 for the current cafeteria plan year (and subsequent cafeteria plan years) by amending the plan document before the end of the current plan year. Thus, if your plan ends June 30, 2005 you may make the election prior to the end of that plan year period.

At TAI, we believe the rollover feature is a welcome change and will minimize forfeitures. More importantly, it will substantially increase enrollment since employees will be less concerned about losing money given the additional time to incur expenses in a new plan year.

Please contact TAI with any questions.

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