

New Grace Period Permitted for Cafeteria Plan Flexible Spending Accounts

The IRS recently announced that a cafeteria plan may extend the period during which reimbursable expenses may be incurred beyond the end of the plan year. Prior to this announcement, employees were required to forfeit any funds remaining in their Flexible Spending Accounts (FSAs) at the end of the plan year. Employers now are permitted to include up to a 2½-month grace period for health care and dependent care FSAs, giving employees more time to spend their FSA funds.

The grace period extension is optional, and will require the adoption of a plan amendment by the end of the cafeteria plan year. Thus, to apply the grace period to calendar year FSAs for 2005, the amendment must be adopted by December 31, 2005.

A grace period also must meet the following requirements:

- It must apply to all participants in the cafeteria plan;
- Unused funds at the end of the grace period continue to remain subject to the forfeiture, or “use-it-or-lose-it,” rules;
- Unused funds relating to a particular benefit may only be used to pay or reimburse expenses incurred with respect to that benefit during the grace period; and
- As under current practice, employers may continue to provide a “run-out” period after the end of the grace period during which expenses incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

Before employers decide whether to add a grace period for their FSAs they should consider the following:

- Can the current administrator or administration system handle a grace period? If so, will claims be applied first to the prior year?
- Will changes to claim forms be required? How will debit cards for FSAs be handled?
- How will the grace period and the rules for accounting for expenses incurred during the grace period be communicated to employees? Should employees be informed that they may want to elect a smaller amount for the next plan year, if expenses incurred in the first several months of the next plan year would be reimbursed with money contributed during the prior plan year?
- Will adding the grace period to dependent care FSAs complicate the completion of Forms W-2, by allowing the amount of dependent care to fluctuate for a longer period after December 31?

If you have any questions regarding the new grace period rules, please contact any of the undersigned members of the Employee Benefits/Executive Compensation Practice Group.

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