



AMAZING GRACE: IRS OFFERS RELIEF FROM USE-IT-OR-LOSE-IT RULE FOR CAFETERIA PLANS

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Amazing grace: IRS offers relief from use-it-or-lose-it rule for cafeteria plans

Employees participating in cafeteria plans typically have had to balance the ability to pay for qualified benefits on a pretax basis against the risk that any unspent contributions would be forfeited at year-end because of the use-it-or-lose-it rule. Recent IRS guidance improves that rule by allowing employers to add up to a two-and-one-half-month grace period to their cafeteria plans. If a plan is amended to add a grace period, employees may carry over year-end account balances and use those funds to reimburse qualifying expenses incurred during the grace period.

Finding your way to 'grace-land'

Complying with the basic grace period requirements is relatively simple:

* Two-and-one-half-month rule. The grace period mustn't extend longer than two months and 15 days after the end of the immediately preceding plan year to which it relates. For example, if a calendar-year plan is amended to add a grace period for the 2005 plan year, the grace period may last until March 15, 2006. The grace period isn't required to last the full two and one-half months and, if desired, may be shorter. Adding a grace period doesn't extend the plan year itself.

* All participants. If a grace period is offered, it must be offered to all participants in the cafeteria plan. That's generally understood to mean all individuals who are active participants on the last day of the plan year, even if those individuals don't enroll in the plan for the next plan year. In the case of a health flexible spending account (FSA) plan, that includes individuals participating in the plan on the last day of the plan year under a COBRA election.

* Same qualified benefits. Carryover amounts contributed to a cafeteria plan for a particular qualified benefit may be used only to reimburse expenses incurred during the grace period for that same qualified benefit. For example, amounts contributed to a health FSA plan may not be used to reimburse dependent-care expenses incurred during

the grace period.

* Runout period still permitted. A plan may continue to provide for a runout period during which expenses incurred during the plan year may be submitted for reimbursement after the plan year. The runout period may run concurrently with the grace period or may be added to the end of the grace period. For example, a plan that allows a 90-day runout period may provide either that claims for reimbursement may be submitted for 90 days after the end of the plan year or that claims may be submitted for 90 days after the end of the grace period.

* Use-it-or-lose-it rule still applies. To the extent carry-over amounts exceed expenses incurred during the grace period, the use-it-or-lose-it rule still applies as of the end of the grace period, and any excess at that time must be forfeited.

* Must amend by year-end. To add a grace period to a plan for the current plan year, the plan document must be amended by the end of the plan year. Given that rule, employers wishing to add a grace period to their plans for the current year will need to amend their plan documents promptly and may want to contact legal counsel soon.

Grace is easier said than done

There are both positive and negative aspects to a grace period that you'll need to consider in deciding whether to add the grace period to your cafeteria plan.

Prevent year-end spending spree. The addition of a grace period may keep employees from engaging in year-end spending sprees (such as scheduling doctor visits, purchasing eyeglasses, or filling prescriptions) as they seek to use up excess contributions rather than forfeit them.

Reduce forfeitures. The addition of a grace period, however, may reduce forfeitures you have relied on to offset losses or costs of administration.

Encourage reimbursement of large expenses. Because expenses incurred during a grace period effectively may be reimbursed from contributions for two years, adding a grace period also may encourage greater use of a cafeteria plan to reimburse large expenses, which may expose you to an increased risk of loss under the uniform coverage rule.

For an employer that decides to add a grace period to its cafeteria plan, there are a number of additional issues to consider:

Interaction with health savings accounts. In general, coverage under a health FSA is considered low-deductible coverage that prevents an employee from qualifying to make contributions to a health savings account (HSA). If an employee is covered under a health FSA in one year but wants to elect coverage under a high-deductible health plan and make HSA contributions in the next year, his ability to submit claims for reimbursement under the FSA during a grace period in the second year may prevent him from qualifying to make HSA contributions. (The IRS recently announced that it expects to provide guidance on that issue in the near future.)

COBRA. Adding a grace period to a health FSA raises COBRA questions, such as whether a qualifying event occurring during a grace period gives a participant the right to make a COBRA election and whether a qualified beneficiary is required to pay a COBRA premium for coverage during a grace period. The answer to both those questions appears to be no, but in the absence of clearer guidance, any such situations will need to be evaluated carefully on their facts.

Dependent-care assistance plans. Under current IRS guidance for reporting dependent-care assistance plan (DCAP) contributions and reimbursements on an employee's W-2, the addition of a grace period to a DCAP may cause an employee to be taxed on any unspent contributions carried over from one calendar year to the next. The IRS has indicated it will provide further guidance on that issue. In the meantime, however, employers may not want to offer grace periods in their DCAPs. Because forfeitures in a DCAP are relatively rare, a decision not to add a

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grace period to a DCAP should affect few employees.

Ordering rules. Consideration should be given to which "bucket" of money (current-year money or prior-year money) claims incurred during the grace period will be reimbursed from. IRS guidance presumes that claims will be paid first from prior-year funds (a first in, first out approach), but that isn't required. Consideration also should be given to whether reimbursements will be final once processed or whether employees will be offered a "do-over" to ensure claims are processed in the most advantageous way.

Service providers. An employer wishing to add a grace period to an FSA plan will need to check with any third-party administrators or other service providers (e.g., electronic debit card providers) to determine whether they are capable of administering plans with grace period features.

Amendment and communication. A grace period amendment will need to be made and communicated to employees as soon as possible before the end of the plan year to maximize the benefit of the grace period. If possible, communication also should be made in advance of open enrollment so employees can plan accordingly when making contribution elections.

Grace under pressure

Many employees may consider even this limited relief from the use-it-or-lose-it rule to be a valuable feature of their cafeteria plans. Employers considering a grace period amendment will want to contact their legal counsel or other regular benefits advisor soon to discuss these issues and determine the best approach for their plans.

Douglas L. Hanisch and Jason P. Lacey regularly represent clients in employee benefits and Employee Retirement Income Security Act (ERISA) matters. If you have any questions about this new IRS guidance or employee benefits and ERISA in general, you can contact them by telephone at (316) 267-6371 or by e-mail at dhanisch@foulston.com or jlacey@foulston.com.

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