



Treasury and IRS Extend Time to Incur Expenses in Cafeteria Plans

June 15, 2005

On May 18, the Treasury Department and the IRS published Notice 2005-42, which modifies the current prohibition on compensation deferral in the proposed cafeteria plan regulations under section 125 of the Internal Revenue Code. The proposed regulations currently prohibit the deferral of compensation by carrying over or cashing out unused elective contributions or plan benefits from one plan year to another. Accordingly, participants currently must use any contributions remaining in the plan at the end of the plan year, or forfeit such amounts. This is commonly referred to as the “use it or lose it” rule.

Notice 2005-42 permits employers, at their option, to amend their cafeteria plans to provide for a grace period of up to two and one-half months after the end of each plan year, during which period expenses incurred for qualified benefits may be paid or reimbursed from any unused contributions remaining at the end of the prior plan year. In other words, if an employer amends its cafeteria plan to include a grace period (not to exceed two and one-half months), then a participant who has unused contributions relating to a particular qualified benefit from the prior plan year and incurs expenses for that same qualified benefit during the grace period may be paid or reimbursed for those expenses from the unused contributions as if the expenses had been incurred in the prior plan year. Notice 2005-42 effectively gives participants up to 14½ months to use contributions for a plan year before those amounts are forfeited. Any contribution remaining unused after the grace period will be subject to the “use it or lose it” rule, as before. IRS Notice 2005-42 requires the grace period to apply to all plan participants on a uniform basis. This ruling will apply primarily to health care and dependent care flexible spending accounts.

The plan may not permit unused contributions to be cashed out or converted to any other taxable or nontaxable benefit during the grace period. The plan must pay or reimburse expenses incurred with respect to a particular qualified benefit from unused contributions relating to that particular qualified benefit only. For example, unused amounts elected to pay or reimburse medical expenses may not be used to pay or reimburse dependent care or other expenses incurred during the grace period. Employers may adopt a grace period for the current plan year and subsequent plan years by amending the plan before the end of the current plan year.

By permitting a grace period, Notice 2005-42 has the effect of minimizing the impetus for a year-end spending rush prompted by the “use it or lose it” rule. Notice 2005-42 also has the effect of increasing plan administrative expenses if the plan is designed to have expenses paid by participant forfeitures, since forfeitures will likely be reduced by any grace period. Employers that wish to adopt the grace

period should inform plan participants during open enrollment so that participants may adjust their elections for the upcoming year accordingly, particularly with respect to dependent care plan elections. Employers offering a grace period will likely also want to extend the deadline for submitting and filing claims, at least for those expenses incurred during the grace period. Expenses incurred in the grace period may also raise ancillary issues regarding the annual income exclusion for dependent care expense reimbursement.

According to reports, it is the IRS's informal position that coverage under a health flexible spending account during the grace period may constitute "other coverage" that could cause an employee to be ineligible to make contributions to a health savings account, even if the flexible spending account has no remaining assets during the grace period.

If you would like further information regarding the issues raised in this LawFlash, or would like assistance in amending plans, please contact your regular Morgan Lewis attorney, or any of the following:

Chicago

David Ackerman	312.324.1170	dackerman@morganlewis.com
Brian D. Hector	312.324.1160	bhector@morganlewis.com

Dallas

Riva T. Johnson	214.438.1557	riva.johnson@morganlewis.com
John A. Kober	214.438.1552	jkober@morganlewis.com
Erin Turley	214.438.1558	eturley@morganlewis.com

New York

Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Brian J. Dougherty	215.963.4833	bdougherty@morganlewis.com
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
Vivian S. McCardell	215.963.5810	vmccardell@morganlewis.com
Joseph E. Ronan, Jr.	215.963.5793	jronan@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com
R. Randall Tracht	412.560.3352	rtracht@morganlewis.com

San Francisco

Mark H. Boxer	415.442.1695	mboxer@morganlewis.com
Eva P. McComas	415.442.1249	emccomas@morganlewis.com

Washington, D.C.

Althea R. Day	202.739.5366	aday@morganlewis.com
Gregory L. Needles	202.739.5448	gneedles@morganlewis.com
Gary G. Quintiere	202.739.5290	gquintiere@morganlewis.com

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