



Electronic Dispatch

Employee Benefits Law Information Memo

June 2005

[Go to BS&K Employee Benefits Home Page](#)

IRS MODIFIES “USE IT OR LOSE IT” RULE IN CAFETERIA PLANS

Employees will be permitted to carry over excess contributions in a Section 125 cafeteria plan for use in the first 2½ months of the following plan year if an appropriate plan amendment is made, according to a notice recently issued by the Internal Revenue Service (“Notice”). After this 2½ month grace period (“Grace Period”) ends, any remaining funds must be forfeited. This Grace Period is distinct from the typical period following year-end when claims incurred during the preceding plan year may be presented for payment. If amended, a cafeteria plan may accept claims incurred during the Grace Period for payment. The plan also may provide for an additional period following the end of the Grace Period to process claims that were incurred during the Grace Period.

Background

A cafeteria plan may not provide for deferred compensation. Prior to the Notice, it was generally accepted that a carry-over of unused elective contributions or plan benefits (e.g., unused health benefits) from one year to the other was an impermissible deferral of compensation. Consequently, any amounts remaining at the end of a plan year (for example, in a health flexible spending account or in a dependent care flexible spending account) were required to be forfeited unless used to reimburse qualified expenses incurred by the last day of the plan year. This is referred to as the “use it or lose it” rule.

In the Notice the IRS acknowledges that, in other areas of tax law, compensation for services performed in a prior year generally is not considered to be deferred compensation if it is paid within 2½ months following the end of the year in which the services were performed. For example, the legislative history of the recently enacted Section 409A of the Internal Revenue Code (“Code”), relating to nonqualified deferred compensation, indicates that annual bonuses or other compensation paid within 2½ months after the close of the taxable year in which the services were performed is not deferred compensation subject to Code Section 409A. This provided the room the IRS needed to loosen the “use it or lose it” rule.

Amendment Required

To allow employees to take advantage of the new 2½ month Grace Period, a cafeteria plan must be amended before the end of the plan year. In other words, for a calendar year plan to permit 2005 plan year contributions to be used for qualified expenses incurred in the first 2½ months of 2006, the plan must be amended by December 31, 2005.

Administrative Considerations

When considering whether to amend a cafeteria plan to add the 2½ month Grace Period, an employer should review several issues. First, the “use it or lose it” rule is a counterbalance to the “period of coverage” rule in a health flexible spending account which requires that the entire amount elected for reimbursement in such an account be available throughout the period of coverage (typically, the plan year), regardless of how much has been contributed at the time a claim is made. The Grace Period may result in fewer forfeitures, thus increasing the employer’s risk as a result of the period of coverage rule.



A cafeteria plan should adopt procedures that claims presented during the Grace Period are deducted first from any account balance remaining from the prior plan year, and then from the contributions elected for the current plan year.

Finally, a change in a cafeteria plan to incorporate the 2½ month Grace Period should be clearly communicated. To the extent a cafeteria plan is subject to the requirements of the Employee Retirement Income Security Act, the change should be described in a summary of material modifications or in a revised summary plan description. Cafeteria plan participants who are given a Grace Period should consider the effect of the carry-over on their elections during the annual election period for the next plan year.

If you have any questions, please contact any of the following members of our Employee Benefits Law Group:

In Central New York, call 315-218-8000 or e-mail:

Lisa A. Christensen	lchristensen@bsk.com
Stephen C. Daley	sdaley@bsk.com
John C. Godsoe	jgodsoe@bsk.com
Brian K. Haynes	bhaynes@bsk.com
Richard D. Hole	rhole@bsk.com
Ted Lewkowicz	tlewkowicz@bsk.com
Aaron M. Pierce	apierce@bsk.com

In the Capital District, call 518-533-3000 or e-mail:

Joanmarie M. Dowling	jdowling@bsk.com
Amelia M. Klein	aklein@bsk.com

In Western New York, call 716-566-2800 or e-mail:

Darcie A. Falsioni	dfalsioni@bsk.com
--------------------	-------------------

In New York City and on Long Island, please contact either of the following members of our Labor and Employment Law Department:

On Long Island, call 516-267-6300 or e-mail:

Terry O'Neil	toneil@bsk.com
--------------	----------------

In New York City, call 646-253-2300 or e-mail:

Louis P. DiLorenzo	ldilorenzo@bsk.com
--------------------	--------------------