



SITZMANN • MORRIS • LAVIS
I N C O R P O R A T E D

May 22, 2005

Legislative Update: IRS Notice 2005-42
Section 125 – Cafeteria Plans -- Modification of Application of Rule
Prohibiting Deferred Compensation Under a Cafeteria Plan

Summary: This notice permits a grace period immediately following the end of each plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during the grace period.

- The grace period must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., “the 2 and 1/2 month rule”). For calendar year plans, March 15. Can extend for less than 2 ½ months.
- The effect of the grace period is that the participant may have as long as 14 months and 15 days (the 12 months in the current cafeteria plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are “forfeited” under the “use it-or-lose-it” rule .
- An employer may adopt a grace period as authorized in this notice for the current cafeteria plan year (and subsequent cafeteria plan years) by amending the cafeteria plan document before the end of the current plan year.
- The grace period must apply to all participants in the cafeteria plan.
- Unused benefits or contributions relating to a particular qualified benefit may only be used to pay or reimburse expenses incurred with respect to that particular qualified benefit. For example, unused amounts elected to pay or reimburse medical expenses in a health flexible spending arrangement (FSA) may not be used to pay or reimburse dependent care or other expenses incurred during the grace period.
- During the grace period, a cafeteria plan may not permit unused benefits or contributions to be cashed-out or converted to any other taxable or nontaxable benefit.
- As under current practice, employers may continue to provide a “run-out” period after the end of the grace period, during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

The rules of this notice are illustrated by the following examples:

Example (1). Employer with a cafeteria plan year ending on December 31, 2005, amended the plan document before the end of the plan year to permit a grace period which allows all participants to apply unused benefits or contributions remaining at the end of the plan year to qualified benefits incurred during the grace period immediately following that plan year. The grace period adopted by the employer ends on the fifteenth day of the third calendar month after the end of the plan year (March 15, 2006 for the plan year ending December 31, 2005). Employee X timely elected salary reduction of \$1,000 for a health FSA for the plan year ending December 31, 2005. As of December 31, 2005, X has \$200 remaining unused in his health FSA. X timely elected salary reduction for a health FSA of \$1,500 for the plan year ending December 31, 2006. During the grace period from January 1 through March 15, 2006, X incurs \$300 of unreimbursed medical expenses (as defined in § 213(d)). The unused \$200 from the plan year ending December 31, 2005 is applied to pay or reimburse \$200 of X's \$300 of medical expenses incurred during the grace period. Therefore, as of March 16, 2006, X has no unused benefits or contributions remaining for the plan year ending December 31, 2005. The remaining \$100 of medical expenses incurred between January 1 and March 15, 2006 is paid or reimbursed from X's health FSA for the plan year ending December 31, 2006. As of March 16, 2006, X has \$1,400 remaining in the health FSA for the plan year ending December 31, 2006.

Example (2). Same facts as Example (1), except that X incurs \$150 of § 213(d) medical expenses during the grace period (January 1 through March 15, 2006). As of March 16, 2006, X has \$50 of unused benefits or contributions remaining for the plan year ending December 31, 2005. The unused \$50 cannot be cashed-out, converted to any other taxable or nontaxable benefit, or used in any other plan year (including the plan year ending December 31, 2006). The unused \$50 is subject to the "use-it-or-lose-it" rule and is "forfeited." As of March 16, 2006, X has the entire \$1,500 elected in the health FSA for the plan year ending December 31, 2006.