Section 125 Plans: Grace Periods Allowed

Internal Revenue Code Section 125 allows employees to make pre-tax contributions to a Flexible Spending Account (FSA). Employees may seek reimbursement from the FSA for expenses paid for child care and eligible medical expenses not otherwise covered under a health insurance plan. FSAs are subject to the “use-it-or-lose-it” rule. Thus, as a general rule, any money remaining in the FSA at the end of the Section 125 plan year must be forfeited.

The Treasury Department and the IRS released guidance in Notice 2005-42, Notice 2005-86 and proposed Section 125 regulations that allows Section 125 plans to incorporate a grace period after the end of the plan year. The grace period serves as an exception to the general “use-it-or-lose-it” rule by allowing plan participants to incur eligible medical expenses for a period of time after the plan year ends.

When may employers permit grace periods within their Section 125 Plans?

Grace periods are an optional plan design feature. At the employer’s option, it may allow a grace period within its Section 125 Plan. The grace period must apply to all participants in 125 Plan.

If an employer decides to add a grace period to its Section 125 Plan, it must amend the plan documents to describe the grace period. In general, if a grace period is added for the current plan year, the plan amendment must be adopted by the end of the current plan year. Employers that add grace periods to their Section 125 Plans should communicate this benefit change to employees.

How long is the grace period?

The proposed regulations state that a cafeteria plan may “include a grace period of up to the fifteenth day of the third month immediately following the end of each plan year.” In other words, employers may add up to a 2 ½-month grace period to the end of their Section 125 Plan year. For example, a Section 125 Plan with a plan year ending on Dec. 31, 2011, may incorporate a grace period that allows plan participants to continue to incur expenses through March 15, 2012.
Section 125 Plans: Grace Periods Allowed (continued)

How does a grace period differ from a “run-out” period?

A grace period extends the amount of time in which participants may incur expenses.

A run-out period allows employees to submit eligible expenses after the close of the plan year. Unlike a grace period, expenses submitted during the run-out period must have been incurred prior to the end of the plan year. The proposed Section 125 regulations specifically provide that a cafeteria plan is permitted to contain a run-out period as designated by the employer. Employers that choose to allow a grace period within their Section 125 Plans should also consider amending their plans to allow the run-out period to begin on the last day of the grace period.

Can a Section 125 Plan allow unused benefits or contributions to be cashed out or carried over?

No. Although the proposed regulations allow a Section 125 Plan to incorporate a grace period, unused benefits or funds within the plan or FSA at the end of the grace period continue to remain subject to the use-it-or-lose-it rule.

May a grace period be applied to both a health FSA and a dependent care spending account (DCAP)?

Yes. However, health FSA and DCAP funds must be kept completely separate, even during a grace period. For example, unused funds within a health FSA may not be used to pay or reimburse dependent care expenses incurred during the grace period. Employers considering allowing a grace period for funds held in a DCAP should work with their plan administrator or legal counsel to amend their plan in a way that does not allow employees to violate statutory contribution limits and takes into consideration the DCAP’s interaction with dependent care tax credits.

If an employer amends its Section 125 Plan during the current plan year to incorporate a grace period, may employees increase their contribution to their FSAs?

No. Employees are only permitted to make mid-year FSA election changes following certain events, such as change in status events. A change in status includes marriage, birth, adoption or change in employment status. An employee may also change his or her FSA election at the beginning and end of a Family and Medical Leave Act (FMLA) leave.
Section 125 Plans: Grace Periods Allowed (continued)

If an employer amends its Section 125 Plan to incorporate a grace period, when will expenses be eligible for reimbursement from a health FSA?

The following example demonstrates how a grace period applies to a health FSA:

Example

Employer’s Section 125 Plan year ends on Dec. 31, 2011. The employer amends its plan document prior to the end of the plan year to allow a 2 ½ month grace period. The grace period ends on March 15, 2012.

Employee elects to contribute $1,000 to his health FSA for the 2011 plan year. As of Dec. 31, 2011, Employee has $200 remaining in his health FSA. Employee also elects to contribute $1,000 to his health FSA for the 2012 plan year.

On Jan. 15, 2012, Employee incurs $250 in unreimbursed medical expenses when he purchases a pair of glasses. Employee submits this claim for reimbursement in a timely manner. Employee is reimbursed $200 from the unused funds within his health FSA for the 2011 plan year. The remaining $50 of unreimbursed medical expenses is paid to Employee from funds within his health FSA for the 2012 plan year. The grace period within a health FSA not only provides employees with an additional 2 ½ months to incur claims, but it also provides employees with “overlapping coverage.” In this example, Employee is covered under the two health FSA plan years during the 2 ½ month grace period.

If an employer amends its Section 125 Plan to incorporate a grace period, is it possible to transition from an FSA to an HSA?

Yes. If an employee is covered under an FSA during a grace period, he or she would generally be ineligible for HSA contributions. However, in Notice 2005-86, the Treasury Department and the IRS clarified how an FSA could be amended to enable a covered individual to contribute to an HSA during the grace period. If an employer amends an FSA to be HSA-compatible during the grace period for all participants, individuals would not be disqualified from contributing to an HSA during the grace period.

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