



Benefits Briefing

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Editor's Note

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In an effort to keep you informed of regulation issues and new developments, we will be sending quarterly issues of our newsletter, Benefits Briefing. If there are HR contacts at your company who would benefit from this, please give us their names and email addresses, and we will add them to the distribution list.

Treasury and IRS Extend Time to Spend FSA Funds

On May 18, 2005 the Treasury Department and the IRS issued Notice 2005-42 allowing employers to extend the deadline for incurring and filing Health and Dependent Care Reimbursement Account claims up to 2 and ½ months after the end of a plan year. This ruling should dramatically reduce the “use it or lose it” risk to employees as well as ease the year end spending rush. Additionally, we anticipate it should increase both the number of participants and amounts contributed in future years.

The notice permits an employer to amend their plan document to provide a **grace period** immediately following the end of each plan year up to “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 ½ month rule)” – March 15th for calendar year plans. Expenses incurred during the **grace period** may be paid from unused balances from the preceding plan year. The employer may also provide an extended “run-out” for those expenses incurred during the **grace period** and the plan year to be submitted and paid. In other words, employers with calendar year plans may want to change the deadline for filing claims from March 31 to June 15. Employers must formally amend their plan documents before the last day of the plan year to take advantage of this ruling.

Although this is good news for FSA participants, it will create administrative and compliance issues for employers and administrators. This entire Benefits Briefing is dedicated to the Notice and its effect on Cafeteria Plans. You may link to the full text of the Notice at: <http://www.treasury.gov/press/releases/js2456.htm>

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Treasury/IRS Officials Comment on the New "Grace Period"

The Employers Counsel on Flexible Compensation (ECFC) sponsored a conference call with comments and questions and answers from Treasury Department and IRS Officials on May 27, 2005. Participants included IRS officials Harry Becker, Health & Welfare Branch Chief, Elizabeth Purcell, Assistant Health & Welfare Branch Chief, Senior Counsel-COBRA specialist, Treasury Department Senior Attorney, Kevin Knopf, ECFC president Bonnie Whyte, and ECFC members John Hickman, Esq. and Ashley Gillihan, Esq.

Harry Becker’s comments included:

- Employers could amend any current 04/05 plan year as well as 2005 calendar year plans as long as the amendment was adopted prior to the last day of the plan year
- Employers may cap the carry over amount
- Employers may limit the **grace period** benefits paid to specific benefits. (For example, if an employer was planning to offer Qualified High Deductible Health Plan with an HSA in the upcoming plan year, they could limit the grace period benefits to “non-medical” expenses so as not to disqualify a participant from eligibility in the HSA. Treasury’s Knopf confirmed that in his view, adopting a grace period into a plan year where a participant was covered under a QHDP would disqualify the

participant from an HSA.)

- The employer may extend the “run-out period” for paying claims to any length and may, but are not required to, have different “run-out periods” for claims incurred during the plan year and claims included during the **grace period**.

Other topics addressed in the Q & A portion of the call included:

- Although there is currently no official Treasury position, informally COBRA and HIPAA issues are not a concern.
- For participants ceasing to participate early in the plan year who do not elect COBRA for an FSA, no **grace period** would apply.
- A participant would not have to elect to participate in an FSA for the new plan year to get the benefit of the grace period for the old plan year.
- There was significant discussion of the possible W-2 reporting requirements for Dependent Care Assistance Plans where benefits were carried over and actual benefits paid in a calendar year exceeded the current \$5,000 tax free limit. Because of the complexity of this issue, it was suggested that employers may want to limit the grace period to Health Care Reimbursement Accounts only.
- Neither Treasury nor the IRS has suggested any “Model Amendment Language”.

Finally, Bonnie Whyte indicated there were still several congressional bills pending that might affect FSA carryovers and Flex Plans. We will continue to monitor these bills and include updates in future Benefits Briefings.

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Administration Issues

How does an administrator know whether to apply a claim incurred during the 2 and ½ month carryover period to outstanding previous year balances or the new plan year? That is one of the biggest issues plans and administrators will have to address when taking advantage of the new **grace period**. When paying claims incurred during the new 2 and ½ month period after the end of a plan year, which plan year should the claim be applied to.

The three most plausible approaches seem to be:

1. Require participants to indicate on the claim form which year to apply the claim to. This approach will be particularly difficult for plans using debit cards. It also puts a burden on the participant to understand the new rules, know his plan balance, have a current updated claim form, and make the best decision. That may all seem reasonable, but will more than likely cause participant confusion and significant administrative problems (like returned incomplete claim forms). It will be particularly difficult for plans using debit cards.

2. Apply claims incurred in the grace period first to any remaining balance in the prior plan year and once that balance is exhausted, apply to the current plan year. The “Catch 22” comes in to play when a claim incurred in the prior plan year is submitted after a claim incurred during the **grace period**. This could leave an otherwise eligible expense incurred prior to the end of the plan year unreimbursed while a balance remains in the current plan year. This method may also be particularly complicated when debit cards are involved.
3. Apply claims submitted to the plan year in which they were incurred. Then, at the end of the claim run-out period (now possibly extended to 5 and ½ months after the end of the plan year), look back to see if any balance remains in the prior plan year and make an “adjustment” for eligible grace period claims back to the prior plan year balance for the lesser of the prior year balance or the **grace period** claims submitted.

In the May 27, 2005 conference call, the IRS and treasury officials indicated that the method of handling these claims would be left up to the employer and indicated no preference. They also indicated that it might be alright to apply debit cards to the current plan year while first applying paper claims to the old plan year balance.

At this writing, option 3 would seem to be the option that most benefits plan participants. We will be attending the ECFC Annual Cafeteria Plan Symposium for Administrators in August where many nationwide administrators will gather to meet with the IRS and Treasury officials and discuss these and many other issues affecting plans. We hope to have formal recommendations ready after that meeting and publish them in the September 2005 Benefits Briefing.

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What Do Plan Sponsors Need to Do?

To take advantage of the new **grace period**, an employer must formally amend the plan document and communicate the change to participants by the last day of the plan year. We anticipate that almost all employers will want to amend their plans. Before writing the amendment, they need to consider the following options:

- The grace period may be up to the 15th day of the third month following the end of the plan year, but can be shorter. We assume most employers will choose the full 2 and ½ month period.
- The employer may cap the carry over amount at a fixed dollar limit – say \$500. We don't expect that to be common.

- The employer may limit the benefits paid for grace period claims to specific benefits. This might be appropriate when introducing a “Consumer Driven Health Plan” option in the new plan year that includes a Health Savings Account (HSA). In this case, you might limit benefits to “non-medical” dental and vision expenses. Treasury officials have indicated that if that limitation was not in effect, the participant would be ineligible for the HSA.
- The employer may extend the run-out period for filing claims (commonly 90 days after the end of the plan year). That might change the end of the period from March 31 to June 15 in some plans. The IRS officials have indicated that they have no guidance and that the employer may choose any period they deem appropriate.
- The employer may choose to have separate run-out periods for claims incurred during the plan year and during the **grace period** (i.e., March 31 for claims incurred during the plan year and June 15 for claims incurred during the **grace period**). That would seem to cause more confusion for participants and administration problems than it is worth.
- The employer may choose to have a grace period for the Health Care Reimbursement Account, but not the Dependent Care Reimbursement Account. There is currently some confusion about how to report the Dependent Care benefit on the employees W-2 when claims are carried over and more than the current \$5,000 statutory limit would be paid during a calendar year. Hopefully, IRS and Treasury will offer some guidance prior to the end of the year on this issue.

With these questions answered, the plan sponsor should be prepared to amend and communicate the changes to plan participants. Neither the IRS nor Treasury has suggested model amendment language.

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IRS Publication Links

With tax season upon us we wanted to provide you with some handy links to IRS Publications that may help you and your employees. We hope they are helpful to you.

[IRS Publication 502 \(Health Care\)](#)

[IRS Publication 503 \(Dependent Care\)](#)

[IRS Publication 969 \(HSAs and Other Tax-Favored Health Plans\)](#)

[IRS Publication 968 \(Adoption\)](#)

[Other IRS Publications](#)

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