

EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION ADVISORY

May 2005

IRS DEFERS (BUT DOES NOT ELIMINATE) CAFETERIA PLAN AND FSA FORFEITURES

FLEXIBLE SPENDING ACCOUNTS NOW HAVE ROLLOVERS. Well, sort of. Treasury issued Notice 2005-42 on May 18, 2005, which allows plan sponsors to design their plans to allow for an additional period of time (or “grace period”) of up to 2 ½ months following the end of each plan year to incur expenses before the “use it or lose it” forfeiture rule applies. Thus, by plan design, expenses incurred within 2 ½ months after the close of the plan year can be reimbursed with funds carried over from the prior plan year. However, any unused amounts from the prior plan year that are not used to reimburse expenses by the end of the grace period remain subject to the “use it or lose it” rule and must be forfeited.

The bottom line – the IRS has delayed (but has not eliminated) application of the use it or lose it rule. While not quite the result hoped for by many in the benefits community, the new rule will operate to temporarily delay the use it or lose it rule and allow participants additional time to use elected benefits. As stated by Treasury Secretary John Snow – “The new rule will give workers with FSAs more time to pay for medical and dependent care expenses and will ease the year-end spending rush prompted by the prior rule.”

The Administrative Horrors: Unfortunately, as is so often the case when a holistic solution is set aside for an “incremental fix,” the new rule does NOT fit well with existing law and may result in a host of administrative and compliance headaches. Undoubtedly, the new rule will require system changes – much more than treating the new grace period as a run-out period. In addition, in the absence of further corrective clarification, the rule as written could create additional HIPAA and COBRA compliance obligations for Health FSAs.

In this article we discuss how Treasury crafted this rule (notwithstanding the prohibition on “deferred compensation”). We also address the steps necessary to implement the rule (including plan design options afforded by the rule) and the administrative issues created by the rule. While the new rule is a step in the right direction, we continue to believe that further agency relief (i.e., eliminating the use it or lose it rule completely) is consistent with Congressional guidance.

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The Deferred Compensation Prohibition

The use it or lose it rule arises from the Section 125 prohibition on deferred compensation in cafeteria plans. See Code Section 125(d)(2)(A). In 1984, Treasury concluded in proposed regulations that a cafeteria plan that permits employees to carry over unused elective contributions or plan benefits from one plan year to another *operates to defer compensation* in violation of the statute as does the use of contributions from one year to purchase benefits in another year (see Prop. Treas. Reg. 1.125-1 Q&A-7). Consequently, participants must forfeit or “lose” any amounts that they do not use to pay for expenses incurred during the plan year. Likewise, participants may not use salary reductions from one year to purchase insurance provided in a subsequent year. Treasury has been insistent (most recently in a response to Senator Grassley) that the deferred compensation prohibition prohibits any carryover of benefits from one year to the next. So where do we get the grace period?

The new rule is based on the premise that the grace period’s limited duration (2 ½ months) does not result in a deferral of compensation. This premise is based on the concept that a plan does not defer the receipt of compensation if benefits are provided for only a “brief” period of time after the end of the plan year. This concept has been cited in regulations relating to qualified plan deductions (under Section 404(a)) and the Conference Report to the recently enacted 409A nonqualified deferred compensation rules. “Brief,” for purposes of this concept, has been defined to mean a period of time not exceeding the 15th day of the third month after the end of the plan year (i.e., 2 ½ months).

Thus, it follows that since the grace period established under the new rule does not result in deferred compensation, it is permissible under Section 125. Also, Treasury was able to establish the rule without legislative action because it does not run counter to the Code Section 125 statutory prohibition.

Operation of the Rule

Logically speaking, the rule is easy to follow (but that does not mean that it will be easy to administer). Amounts not used for expenses/benefits incurred during the plan year (“Temporary Carry Over Amounts”) may be used for permitted benefits (reimbursement or payment of expenses) incurred during the grace period (up to 2 ½ months) in the following plan year. That’s right!! Amounts from one year may be used for expenses/benefits incurred in a subsequent year but only during the grace period. Any Temporary Carry Over Amounts that are not used for expenses incurred during the grace period are forfeited. That is why we call it a “Temporary Carry Over.” The employer may establish a run out period following the grace period; therefore, the 2 ½ month grace period maximum only applies to the period during which expenses must be *incurred*; not the period during which such

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expenses must be *submitted* for reimbursement (see issues below associated with run out period).

Consider the following examples that illustrate the operation of this rule:

Example #1: In 2005, Johnny elects to contribute \$2000 for reimbursement of eligible medical expenses under the Employer's Health FSA. On December 31, 2005, Johnny has only incurred \$1000 in expenses; therefore, he has a \$1000 Temporary Carry Over Amount following the 2005 plan year. For 2006, Johnny again elects to contribute \$2000. Johnny incurs a \$3000 expense on January 15, 2006. Under the new rule, the \$1000 Temporary Carry Over Amount may be applied to the \$3000 expense incurred on January 15, 2006. The remaining \$2000 would be available for reimbursement under his 2006 election.

Example #2: Same facts as Example #1, except assume that Johnny only incurs a \$500 expense on January 15, 2006 and he incurs no other expenses during the grace period (which cannot exceed 2 ½ months). In this example, \$500 of the \$1000 Temporary Carry Over Amount may be applied to \$500 expense and the remaining \$500 is forfeited.

The new rule does not only apply to FSAs. It also applies to amounts set aside for coverage. Thus, the new rule resolves a longstanding issue related to the application of employee pre-tax contributions withheld in the last month of the plan year toward the cost of coverage provided in the first month of the subsequent plan year. This is a common practice and IRS officials have informally indicated that they were not bothered by it – but it is nice to have official guidance nonetheless.

Plan Design Options and Implementation of the New Rule

Adoption of the new rule is elective, and employer/plan sponsors will be glad to know that there may be several options from which to choose. While the administrative hassles are not insignificant (see discussion below), we anticipate that most employers will feel pressure to adopt the new rule in some form. The following is a checklist of the potential plan design options and applicable implementation steps:

- 1. Employer must amend the plan to incorporate the rule.* Employer/plan sponsors are not required to implement the rule. However, if an employer decides to implement the rule, the employer must amend the plan document prior to the intended effective date of the rule (i.e., prior to the end of the plan year in which you want the rule to apply). Employers should become familiar with the rule and the issues arising from its adoption before deciding whether to implement it. As noted in more detail below, there are a number of issues that must be addressed.

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Employers may implement the rule *for the current plan year* so long as they amend the plan document prior to the end the current plan year. As with other plan amendments, employer/plan sponsors should amend the plan in accordance with the terms of the plan document and the plan sponsor's rules for taking legal action.

2. If adopted, the grace period must apply to all cafeteria plan participants. The intent of this requirement is obviously to prevent the employer from only offering the grace period to certain cafeteria plan participants (e.g., highly compensated employees). However, a literal interpretation of the requirement would also prevent employers from applying the grace period only to certain benefits (e.g., the Health FSA, but not dependent care). This is because, as literally applied, some employees may not participate in a benefit to which the grace period is extended. We do not think that a literal reading of this requirement was intended. Logically, the rule should be satisfied as long as the grace period is equally available to all participants – even if they do not elect the benefit to which the grace period applies. The Section 125 nondiscrimination rules and the applicable benefit plan nondiscrimination rules should adequately prevent any potential abuses.

3. The grace period may not extend beyond the 15th day of the third month following the end of the plan year; however, it may be shorter. As noted above, the grace period cannot extend beyond 2 ½ months following the end of the plan year; however, employer/plan sponsors may establish a shorter grace period. Some employers may have valid business reasons for limiting the duration of the grace period (for example, the longer the participants have to use the Temporary Carry Over, the less forfeitures they may have to offset administrative expenses).

4. Temporary Carry Over Amounts may not be used for any other taxable or non-taxable benefits. Not surprisingly, unused funds from the health FSA may only be used to reimburse eligible health FSA expenses incurred during the grace period and likewise for unused dependent care amounts. Also, Temporary Carry Over Amounts may not be transferred to an HSA (as we had hoped for and had been proposed in legislation) or to an HRA

5. Determine the run out period, if any, following the grace period. Although not required, an employer/plan sponsor may implement a run out period following the grace period during which participants can submit expenses incurred during the grace period but submitted afterward during the run out period.

Potential Compliance and Administrative Issues and other Outstanding Issues

As noted above, the new grace period rule raises many issues and unresolved questions. The following is a brief overview of the legal and practical

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issues associated with the new grace period rule. For many of the legal issues, additional guidance from Treasury is needed.

The grace period may cause a health FSA to lose its status as an excepted benefit under HIPAA's portability rules.

Most health FSAs currently qualify as an excepted benefit under HIPAA's portability requirements. While likely unintended, implementation of the grace period rule may cause a health FSA that would otherwise be exempt from HIPAA's portability rules to lose its excepted benefit status. This would cause the health FSA coverage to be creditable coverage and result in additional burdensome requirements (e.g., issuance of a HIPAA certificate to all covered employees and dependents when eligibility is lost).

Under the new final HIPAA regulations, a health FSA is considered an excepted benefit for a class of participants if the following conditions are satisfied:

- Other group health plan coverage is available for the year to the class of participants by reason of their employment, and
- The arrangement is structured so that the maximum benefit payable to *any participant* in the class *for the year* does not exceed two times the participant's salary reduction under the arrangement *for the year* or if greater, the employee's salary reduction plus \$500 (emphasis added) (see Labor Reg. 2590.732(c)(3)(v)).

The final HIPAA regulations seem to indicate that if a Health FSA is structured so that *anyone* within a class of participants could conceivably receive more reimbursement during the plan year than is permitted in the second bullet above, then the Health FSA is not an excepted benefit *for the entire class of participants*.

The new grace period rule conceptually will result in situations where participant reimbursement will exceed more than is permitted for the Health FSA to qualify as an excepted benefit. Consider the following example to illustrate this point:

Example: Employer implements grace period rule for Health FSA participants. Employee A has \$1000 in unused funds for 2005. In 2006, Employee A makes a \$400 election. For the first 2 ½ months of 2006, Employee A can receive \$1400 in reimbursements yet need only make a \$400 contribution. For 2006, the maximum reimbursement for Employee A (and any other class participant with similar circumstances) is greater than twice his/her salary reduction and his salary reduction plus \$500.

One favorable interpretation (which we hope that IRS confirms) to resolve this issue is to view Temporary Carry Over Amounts that arise from salary

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reductions as a salary reduction (and not as employer contributions); therefore, for a salary reduction funded plan, the maximum reimbursement would be equal to the employee's salary reduction (even though the salary reductions may have been made in the prior year). This interpretation would be more difficult where benefits are funded all, or in part, by real (i.e., non-salary reduction) employer contributions. In such cases a pro-ration or ordering rule would be required. Another way to resolve this complication would be to view the Temporary Carry Over Amount as a benefit paid in the year in which the salary reductions were made (at least for purposes of this HIPAA rule).

Unfortunately, the literal language of the HIPAA portability rules compare benefits provided during the year to salary reductions made during the year. Thus, read in this manner, the grace period rule would cause all health FSAs to be subject to HIPAA's portability requirements. (Note: As discussed more fully below, if the grace period causes the health FSA to fail to be an excepted benefit, the health FSA will be subject to the full 18/29/36 month COBRA period as opposed to the limited COBRA continuation period applicable only to health FSAs that are excepted benefits.)

As indicated above, we doubt that this was intended; however, additional guidance or clarification from Treasury would be welcome.

The grace period rule may cause the health FSA to be subject to the full COBRA continuation coverage period.

Under COBRA, health FSAs may be subject to slightly less onerous requirements than apply to other medical plans. More specifically, health FSAs are not required to offer COBRA after the end of the plan year in which a qualifying event occurs if both of the following conditions are satisfied:

- The health FSA is an excepted benefit for HIPAA purposes; and
- The maximum amount that the health FSA can require to be paid for a year of COBRA continuation coverage equals or exceeds the maximum benefit available under the health FSA for the plan year.

It is not clear how the Temporary Carry Over Amount will be considered for purposes of determining the applicable COBRA premium for a health FSA (presumably, the mere existence of a carry over could be factored in when determining the cost to the plan to provide coverage during the year). It is conceivable that the Temporary Carry Over created by the grace period rule will result in a benefit for the year that is greater than what the plan could require the qualified beneficiary to pay. Thus, all Health FSAs that implement the grace period may be subject to the full 18/29/36 month COBRA period.

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Also, when COBRA coverage is required to be extended, it is unclear how (or whether) the Temporary Carry Over requirement would apply. Is the additional 2 ½ month period of coverage required to be extended to qualified beneficiaries the same way it is extended to active employees?

Additional guidance on these COBRA conundrums would be welcome.

The grace period may cause dependent care benefits to run afoul of the statutory maximum for the year. In addition, reporting headaches may arise.

Section 129 limits the amount of benefits that may be received under a DCAP plan during a calendar year to \$5000 (if single or married filing jointly) or \$2500 (if married filing separate). The maximum reimbursement is based on the actual benefits received during a calendar year and not necessarily the amount that is salary reduced. Thus, if the new grace period rule is implemented for dependent care benefits, an individual must consider any carryover when making elections for a subsequent year. Consider the following example to illustrate this point.

Example: Employee elects \$5000 under the Dependent Care FSA for 2006; however, Employee uses \$500 of Temporary Carry Over amounts from 2005 to pay for dependent care expenses incurred in 2006. The maximum amount of reimbursement that may be made during the year with 2006 salary reductions is now \$4500 (the \$5000 minus the \$500 reimbursement with Temporary Carry Over funds).

Administrative systems need to be reviewed and likely revised to ensure that the statutory maximum is not exceeded during the year when including any carry over amounts. For example, if the administrative system monitors the maximum benefit by referring to the salary reduction amount for the year, there is a risk that more than the statutory limit will be paid out during the year because it may not take into account the amount received during the year from Temporary Carry Over Amounts from the prior year.

Also, it is unclear how the grace period will affect DCAP W-2 benefit reporting obligations. Presumably, for this purpose, rules analogous to how DCAP benefits are handled during the run-out period would apply.

Can employer/plan sponsors further restrict the Temporary Carry Over Amount?

If an employer adopts the grace period rule, must all unused funds be allowed to be carried over? In other words, can an employer place a cap (by plan design) on the amount that can be carried over (perhaps to address the HIPAA or COBRA issues identified above)? Presumably, such restrictions are permitted. The grace period rule is an optional rule and there is nothing

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in the Notice that prevents an employer/plan sponsor from restricting how much can be carried over.

Does the grace period only apply to current participants?

If an employee terminates employment during the grace period, does the employer/plan sponsor have to allow the employee to continue using the Temporary Carry Over amount? For example, if an employee terminates January 2nd, must the carryover from the prior year still be made available? The answer is not clear. Since the grace period rule is an optional rule, it would appear that a participant is not “entitled” to carry over the unused amounts and thus an employer/plan sponsor could presumably limit the grace period to “participants.”

Likewise, if a participant terminates employment or ceases to be eligible mid-year, can the grace period rule apply to allow the former employee to use his/her unused funds without electing COBRA?

Administrative systems must be reviewed to ensure that the grace period rule can be properly administered.

While easily stated, the grace period rule may be difficult to administer. Administrative systems must be revised to properly track account balances from the prior plan year and segregate them from the current year so that prior year funds are not used to reimburse expenses incurred *after* the end of the grace period. Likewise, procedures must be put in place to charge claims against any carry over first and safeguards must be established to ensure that claims incurred at the beginning of a year are not resubmitted under the current year.

Discrimination Testing Issues

The carryover guidance is silent on how (or whether) the grace period affects discrimination testing requirements. Presumably, grace period claims will be factored into discrimination testing for the prior year. However, this treatment will likely cause tax withholding and reporting problems for plans that are found discriminatory after the close of the grace period. Are benefits for the prior year taxable? If so, in what year?

Irrevocable Election Issues

The carryover guidance is also silent as to how the grace period affects participant elections. Presumably elections for the prior year cannot be changed during the grace period. However, nothing would stop employees from increasing elections (as a result of a permissible election change event) in the waning days of a plan year to purposely maximize their benefit during the grace period? Will election changes be allowed in a subsequent plan year because unanticipated funds pursuant to the Temporary Carryover

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Amount are available from the carry over? Clearly these issues will create communication and administrative hassles for plan sponsors.

Uniform Coverage Rule Continues To Apply

Many employers offset their risk from the “uniform coverage” rule applicable to health FSAs by projected forfeitures. Needless to say, allowing participants an additional 2 ½ months to incur and submit claims will significantly decrease forfeitures.

Parting Thoughts About the New Rule

So the new rule is a good thing, right? We do think it is important to point out that until the use it or lose it rule is eliminated *in its entirety*, the perverse year end (now grace period end) spending frenzy created by such a rule will continue. Nevertheless, even the staunchest opponents of the use it or lose it rule would consider this new “grace period” to be a victory. Treasury has insisted that the *statutory* prohibition against deferred compensation in a cafeteria plan requires the use it or lose it rule; therefore, legislative action is necessary to change the rule. Perhaps Congress will now pick up the reins where Treasury has left off – especially given the unanticipated complexity of the grace period.

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