IRS Extends Flexible Spending Account Forfeiture Deadline

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Since Cafeteria Plans (also called Flexible Spending, Flexible Benefits, and Section 125 Plans) exploded into the benefits community in the 1980s, Flexible Spending Accounts ("FSAs") have becomes a popular way for employees to save pre-tax dollars to use for consumer directed health plans. However, FSAs have always been limited in their participation because of the "use it or lose it" rule. The "use it or lose it" rule requires a participant to spend down the money remaining in their FSA by the end of the Plan Year.

Because of the "use it or lose it" rule, employees have always been reluctant to put any more money into a FSA than they are certain they will use in a given year. However, now there will be no more New Year's Eve dashes to the local drug store for bottles of Aspirin to spend down the FSA. IRS Notice 2005-42 allows employers the opportunity to extend the deadline by which a participant in a FSA must "use or lose" their contributions for 2½ months after the end of the Plan Year. To allow for the extended payment period, an Employer must amend their Cafeteria Plan prior to the end of the Plan Year.

For example, if the Plan Year ends on December 31, an employer must amend the Plan on or before December 31. If the employer amends the plan, it can allow employees the opportunity to wait until March 15 of the following year to spend down their funds in the FSA.

Example 1: Employer adopts a Cafeteria Plan with a Health FSA component. The Plan Year is a calendar year. The employer adopts an amendment allowing for the 2½ month grace period for cafeteria plans prior to December 31, 2005. Employee A has elected to contribute $1200 to the FSA for the year ending December 31, 2005. Employee A has $300 remaining in the FSA as of December 31, 2005. Employee A elects for $1200 to be contributed to the FSA for the year ending December 31, 2006. As of January 1, 2006, Employee A has $1500 in the FSA, of which $300 will be forfeited by March 15, 2006 if not used. On March 1, 2006, Employee A incurs $500 in qualified medical expenses and submits the claim for reimbursement from the Health FSA. $300 is paid from the FSA for the period ending December 31, 2005 and $200 from the FSA for the period ending December 31, 2006. Employee A's FSA balance is $1000, which must be used by March 15, 2007.

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