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Flexible Spending Plan Regs Amended

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As the end of another calendar year quickly approaches, taxpayers may want to start considering year-end tax planning opportunities. One great year-end tax planning tool is the recapture of a taxpayer's own pre-taxed income by incurring medical expenses (glasses, dental, and so forth) paid from remaining amounts in the taxpayer's flexible spending account (FSA). This is not only beneficial for saving tax dollars, but it's beneficial to the taxpayer overall. Why? Any unspent FSA

monies left in the account at the end of the year (December 31) would revert to the employer. Good for the employer, but not so good for the taxpayer. So is there anything that can be done to help save the employee's leftover monies? The Treasury came to the rescue on May 18, 2005, by issuing Notice 2005-42, 2005-23 IRB 1204, which announced amendments to Prop. Reg. §1.125-1 and -2 to permit cafeteria plans (such as FSAs) to adopt a grace period beyond year-end that allows taxpayers to use the benefits or contributions from the preceding plan year.

Under Treas. Reg. §1.125-1, Q&A-22, flexible spending arrangements

(i.e., FSAs) are used to pay benefits, such as medical, legal, or dependent care assistance, that are intended to qualify as nontaxable under the applicable rules of the Code. Under flexible spending arrangements, a participant generally is assured of receiving amounts—in salary, cash, or some other form of payment—available for expense reimbursement during the period of coverage *without* regard to whether the participant incurs those expenses during that period.

Furthermore, Section 125(d)(2)(A) states that the term "cafeteria plan" doesn't include any plan that provides for deferred compensation. Treas.

Reg. §1.125-2, Q&A-5 provides an interpretation of this section by stating, in part, that:

"A plan that permits employees to carry over unused elective contributions or plan benefits (e.g., accident or health plan coverage) from one plan year to another operates to defer compensation. This is the case regardless of how the contributions or benefits are used by the employee in the subsequent plan year (e.g., whether they are automatically or electively converted into another taxable or nontaxable benefit in the subsequent plan year or used to provide additional benefits of the same type)."

The bottom line is that unused contributions or benefits remaining at the end of the plan year are forfeited by the taxpayer to the employer. In other words: Use it, or lose it!

As mentioned earlier, the Treasury helped out by lengthening the period within which the employee has to use their FSA dollars. Notice 2005-42 modifies Prop. Treas. Reg. §1.125-1 and -2 as follows:

"A cafeteria plan document may, *at the employer's option*, [emphasis added] be amended to provide for a grace period immediate-

ly following the end of each plan year. The grace period must apply to all participants in the cafeteria plan. Expenses for qualified benefits incurred during the grace period may be paid or reimbursed from benefits or contributions that are unused at the end of the immediately preceding plan year. The grace period must not extend beyond the 15th day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., two-and-a-half-months). If a cafeteria plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year.”

Notice 2005-42 doesn't include an effective date for applying the grace period, but one might assume from the examples the Notice provides that employers will have the opportunity to revise their current-year plan to allow for the grace period in the 2005 calendar year. Taxpayers and tax practitioners should take note that the grace period isn't automatic. The discretion to include the grace period in the FSA rests with the employer, and the employer must amend its plan documents to include the grace period. Hence, if the plan isn't modified by the employer, for whatever reason, then the December 31 deadline remains in effect.

To illustrate the intention of the

grace period rule, the following two modified examples from the Notice are given.

Example 1: The Jason Company has a cafeteria plan year ending December 31, 2005. The company amends the plan document by December 31, 2005, to permit a grace period that 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 March 15, 2006, for the plan year ending December 31, 2005. Jessica elected salary reduction of \$1,000 for a health FSA for 2005. As of December 31, 2005, Jessica has \$200 remaining in her FSA. Jessica also has timely elected salary reduction for a health FSA of \$1,500 for the year ending December 31, 2006. During the grace period from January 1 through March 15, 2006, Jessica incurs \$300 of unreimbursed medical expenses (as defined in IRC §213(d)). The unused \$200 from the plan year ending December 31, 2005, is applied to pay or reimburse \$200 of her \$300 medical expenses, and the remaining \$100 is charged to the plan year ending December 31, 2006. As a result, Jessica has used all of her 2005 FAS monies and has \$1,400 remaining in her health FSA on March 16 for the plan year ending December 31, 2006.

Example 2: Assume the same facts in Example 1, except that, in this case, Jessica incurs only \$150 of IRC §213(d) medical expenses during the grace period of January 1 through March 15, 2006. This gives her \$50 of unused benefits or contributions for the plan year ending December 31, 2005. The unused

\$50 can't 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. Stated simply, the unused \$50 is subject to the “use it or lose it” rule and is forfeited to her employer. Jessica, in this case, has the entire \$1,500 in her health FSA on March 16 for the plan year ending December 31, 2006.

What does it all mean? In summary, the grace period provision provides taxpayers with a “buffer zone” for claiming pre-taxed FSA dollars. During the two-and-a-half-month grace period, qualified medical expenses can be charged first to the prior year, if any unused amounts remain, and then to the current year. But this is true only if the employer has amended the plan documents to provide for a grace period. The “buffer zone” will require taxpayers and tax practitioners alike to carefully monitor expected medical expenses and unused FSA amounts at year-end so that the taxpayer can better estimate his or her contribution amount for the forthcoming year because the grace period will impact the estimated contribution amount for forthcoming medical expenses. ■

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