



**IRS PROVIDES 2 1/2 MONTH GRACE PERIOD  
FOR “USE-IT-OR-LOSE IT” FUNDS**

**Prepared by:  
Stephen L. Hopkins, Karen S. Johnston & Kristin J. Staffanson**

Employers who sponsor and employees who participate in cafeteria plans are well aware of the “Use It or Lose It” rule under which any unused reimbursement bank for medical or child care expenses are forfeited at year end. The IRS has recently granted employers the ability to provide employees an extra 2 1/2 months after year end in which to incur eligible expenses for reimbursement from their prior year’s reimbursement bank.

**Major Aspects of the New Rule.**

- **Optional.** Implementation of the new grace period is not required but if implemented, it must apply to all participants.
- **Available Immediately.** Employers may implement the grace period for 2005.
- **Requires Plan Amendment.** Employers must amend the cafeteria plan by 2005 plan year end to put the rule into effect now.
- **No Change in Purpose.** As before, funds set aside for a particular purpose (i.e., health care vs. dependant care expense) may not be transferred to another account, cashed out or otherwise applied for another purpose.
- **Maximum Grace Period is 2 1/2 Months.** Employers can provide a shorter grace period.

- **“Run out Period” Unchanged.** As previously allowed, employers may provide a “run out period” for submitting reimbursement requests after the end of the grace period.
- **May Cause Ineligibility for HSA Participation.** The IRS has informally indicated that employers who amend their cafeteria plans to provide the 2 1/2 month grace period may cause employees participating in the cafeteria plan to become ineligible to participate in a high-deductible health plan (HDHP) health savings account (HSA) during the grace period.

**Pros and Cons of Providing Grace Period.** The primary reason to provide a grace period is to benefit employees. The additional period to incur expenses may ease employee concerns over forfeiture and may result in increased participation in these programs.

This increased flexibility does, however, likely come at increased administrative expense.

Systems and procedures will need to be reviewed and changed to accommodate the grace period.

Tracking claims and reimbursements to the appropriate plan year, ensuring that statutory contribution limits for dependent care expenses are not exceeded and performing discrimination testing will be more complicated and therefore more expensive. Moreover, the overlap in plan years may cause confusion for participants in estimating expenses for each plan year and in determining to which plan year expenses incurred during the grace period relate. Other potential issues include availability of the grace period for terminating participants and availability of election changes for the grace period, as well as the HDHP/HSA ineligibility issue noted above.

**Contact Steve Hopkins at (612) 252-2876, Karen Johnston at (612) 252-2871 or Kristin Staffanson at (612) 252-2896 for additional information.**