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PARKER | SMITH | FEEK

Employee Benefit Alert

Change in the Application of the "Use It or Lose It" Rule
IRS Notice 2005-42

Apparently all of the activity in Congress surrounding revisions to Section 125 (Cafeteria Plans) of the Internal Revenue code prompted the IRS to apply some new logic to the "Use It or Lose It" rule under code section 125(d)(2)(A). Specifically, the IRS reasoned that if a business entity can accrue bonuses for up to 2½ months after the close of the business year, and still get a deduction, then an individual covered by a Cafeteria Plan should be able to use 125 Plan funds for expenses incurred up to 2½ months beyond the plan year end.

What Does this Mean to My Plan?

If you amend your Flexible Spending Account (FSA) Plan Document, an employee may incur covered expenses in the 2½ month period following the end of the plan year and use any "excess" account values to pay for them.

Example: Joe signs up for $1,200 of medical and $5,000 of dependent care expenses during the open enrollment for this plan. The plan year goes from May 1, 2005 to April 30, 2006. By April 30, 2006, Joe has used $4,500 of his Dependent Care Account and $900 of his Health FSA. Under the previous rules, Joe would forfeit the $500 in the Dependent Care Account and the $300 in his Health Account on May 1, 2006.

Under the new rule, Joe would have an additional 2½ months (to July 15, 2006) to incur additional expenses to apply independently to the two accounts. He can spend up to $300 on health care expenses and/or $500 on day care expenses, and not be subject to the "Use It or Lose It" rule until July 15, 2006.

This is a huge benefit for employees. It should lessen the concerns about the "Use It or Lose It" rule, and make planning easier. **There are some consequences:**

1. COBRA Participants will also get the additional 2½ months to spend their account balance.
2. Administration costs will increase because in addition to the 2½ month "Grace Period", most plans will continue to offer a 60 or 90 day submission window after the end of the grace period.
3. Employer "savings" for forfeitures will go down.
4. There will be a cost associated with the plan amendment, new Summary Plan Descriptions and new claim forms.
5. Employers may gain additional FICA savings from expanded interest in the plan.

The plan amendment must be signed before the end of your current plan year to have the "Grace Period' apply to you current plan year. The addition of the "grace period" is <u>not</u> grounds for a "family status" change, so participants will not be able to modify their current elections to accommodate the longer "spending period".

Your Parker, Smith & Feek benefits team is available to discuss your options. Please do not hesitate to call to address your plan amendments.

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