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Modification to the "Use it or Lose it" Rule

On May 18, 2005 the U.S. Treasury and IRS issued guidance (Notice 2005-42) modifying the current prohibition on deferred compensation, otherwise known as the "Use it or Lose it" rule. The guidance permits plan sponsors to amend their current cafeteria plan to provide for a grace period immediately following the expiration of the current plan year. The purpose of this change is to limit participant account forfeitures and make participation in a flexible spending account more appealing to eligible employee participants.

Grace Period

Notice 2005-42 allows an employer to provide an additional period at the expiration of the plan year for participants to use their benefits and contributions in their cafeteria plan *before* those amounts are forfeited under the "Use it or Lose it" rule. The grace period immediately follows the current plan year and cannot exceed 2-1/2 months. During the grace period, participants may access unused amounts in their spending accounts to pay for qualified expenses incurred during the grace period. If implemented, the grace period must be applied to all participants under the plan. A grace period can be implemented during the current plan year through an amendment to the plan document prior to the end of the current plan year, or at renewal. Determining whether to provide a grace period on a cafeteria plan is left to the discretion of the employer.

Reimbursement and Runout

By implementing a grace period, participants under a cafeteria plan may have up to 14 months and 15 days to incur reimbursable expenses in their cafeteria plan. At the expiration of the grace period, any outstanding funds in the health and/or dependent care spending accounts remain subject to the "Use it or Lose it Rule" and will be forfeited.

The run out period, (period of time, usually 90 days, where the participant may submit expenses incurred during the previous plan year) will be affected by this change. Plan sponsors/employers adopting a grace period may want to extend the run out period under their cafeteria plan to coordinate with the grace period.

Example

> **January 1, 2005 Tom elects to participate in the health FSA with an annual election of $1,500. The employer amends the cafeteria plan to provide for a 2 -1/2 month grace period. On December 31, 2005 Tom has $500 of unused funds in his health FSA account. On February 1, 2006 Tom incurs expenses amounting in $400. Tom submits the claims for reimbursement March 1.**

In the above example, because the employer adopted a grace period, Tom's expenses incurred February 1, 2006 are eligible for reimbursement from the 2005 plan year funds. On March 1, 2006 Tom is reimbursed $400. There remains a positive balance in Tom's 2005 account for $100. Tom has until March 15, 2006 to incur eligible expenses otherwise those funds are forfeited.

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Action Items

1. As an employer, you will need to determine whether or not to implement the grace period under your cafeteria plan.
2. Should you choose to implement a grace period, then you will need to determine the following:
   a. When to adopt the grace period? (Mid-year or at renewal?)
   b. How long of a grace period would you like to implement (cannot exceed 2 months and 15 days)?
   c. How long of a run out period would you like to implement?
3. Amend the current plan document to reflect the adoption of a grace period under the cafeteria plan.
4. Communicate to participants the additional amount of time under the grace period to incur and submit expenses for their flexible spending accounts.

Kibble & Prentice will assist you in determining whether or not to implement a grace period, the steps involved in the implementation, and communication to current and future participants. For clients with Section 125/Flexible Spending accounts through Kibble & Prentice, we are working with our software vendors to update our system capabilities with this new option for administration. As the process unfolds, we will keep you up to date with relevant changes. The following website provides additional information on this issue:

http://www.treasury.gov/press/releases/js2456.htm

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