

Client Alert

A report
for clients
and friends
of the firm May 2005

IRS Permits Extension of FSA "Use-It-Or-Lose-It" Deadline

On May 18, 2005, the Internal Revenue Service (the "IRS") issued new guidance that allows health care and dependent care flexible spending accounts under cafeteria plans or "FSAs" to permit participants to be reimbursed for expenses incurred as late as 2-1/2 months following a particular plan year. Prior IRS guidance required unused FSA balances to be forfeited at the end of the plan year (e.g., December 31 for calendar year plans). This was referred to as the "use-it-or-lose-it" rule.

IRS Notice 2005-42 changes the "use-it-or-lose-it" rule by allowing employers to amend their cafeteria plans to provide all participants with a 2-1/2 month "grace period" immediately following the end of each plan year. A participant who incurs expenses during the grace period may apply his or her unused FSA balance at the end of the prior plan year to those expenses as if they had been incurred in the prior plan year. Any remaining balances will be forfeited at the end of the grace period.

During the grace period, a cafeteria plan may not permit unused FSA balances to be cashed out or converted to any other taxable or nontaxable benefit (e.g., health FSA balances cannot be used for dependent care expenses). Plan sponsors may continue to provide a "run-out" period after the end of the grace period during which expenses for qualified benefits incurred during the cafeteria plan year and the grace period may be paid or reimbursed.

Plan sponsors that wish to offer the grace period must amend their plan documents by the end of the plan year. For example, to apply the grace period this year for a plan with a 2005 plan year ending December 31,

2005, the plan must be amended by December 31, 2005.

Please contact your Proskauer relationship attorney or any of the attorneys listed below on this Client Alert if you need assistance in amending your cafeteria plan or if you have any questions about this Client Alert.

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