

IRS Eases Use-It-Or-Lose-It Rule

On May 18, 2005, the Internal Revenue Service (IRS) issued Notice 2005-42 in an effort to ease the "use-it-or-lose-it" rule as applied to a Flexible Spending Account (FSA).

Notice 2005-42 allows for an additional 2-½ month "grace period" after the end of the plan year to incur eligible medical and dependent care expenses. If an employer amends its plan, participants could have up to 14-½ months to use their contributions. Employers are not required to adopt the rule. However, if implemented, the plan document must be amended prior to the end of the plan year in which the employer wants the rule to apply. If adopted, the grace period must apply to all cafeteria plan participants, preventing the employer from offering the grace period to only certain participants, such as highly compensated employees.

As previously mentioned, the grace period allows for an additional 2-½ months, therefore, it may not extend beyond the 15th day of the third month following the end of the plan year. However, it may be shortened to establish a shorter grace period. Some employers may want to limit the duration of the grace period to limit the time participants have to incur eligible expenses, allowing less time for forfeitures that could be used to offset administrative expenses. Additionally, although it is not required, an employer may also implement a run out period following the grace period, allowing more time for participants to submit expenses incurred during the grace period. Employers may want to amend their plans to allow this grace period at the end of the plan year, and also reduce the run out period from 90 days to 45 days after the end of the plan year. For example, on a calendar year plan, the plan year would end on December 31, 2005, the grace period would end on March 15, 2006, and the plan would "close" for claim payments on April 30, 2006.

At the end of the grace period, unused amounts cannot be transferred to another benefit. This longstanding rule was not altered by the grace period option. Further, amounts left unused at the end of the grace period are still forfeited.

Although this rule appears straightforward, there are several unresolved issues. Recently, IRS representatives participated in an informal panel discussion that provided insight into their thinking. For example:

- Can an employer cap the maximum amount that can be carried into the grace period? During the informal panel discussion, the IRS representatives said that an employer probably could do so if the cap amount applied uniformly to all participants.
- Must the grace period apply to all plan benefits or can it be applied to a specific benefit? It appears that the IRS will allow an employer to choose which benefits apply to the grace period.
- Which participants are covered by the grace period? The informal advice indicates that participants, as of the last day of the plan year, are the ones entitled to the grace period. Currently, most health FSAs qualify as an excepted benefit under HIPAA's portability requirements.

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- Would implementation of the grace period rule cause a health FSA to lose the excepted benefit status under HIPAA? This could cause the health FSA plan to be subject to creditable coverage rules, special enrollment and other HIPAA-related requirements.
- Would a health FSA that is not an excepted HIPAA benefit be subject to the full 18-, 29- or 36-month COBRA period rather than the limited COBRA continuation period, which is the remainder of the plan year? The informal comments made by the IRS stated the grace period would not cause a health FSA to lose its status as an excepted HIPAA benefit. In addition, a COBRA participant, who has FSA continuation coverage at the end of the plan year, would be entitled to the grace period.

We hope the IRS will provide more detailed information on the above issues to clarify proper procedures.

Contact your Mesirow Financial representative if you have any further questions.

Source: Infinisource

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