

May 18, 2005

IRS Eases “Use It or Lose It” Rule for Flex Accounts

The IRS has just announced a significant change in the rule that requires participants in a flexible spending account (FSA or flex) plan to forfeit any amount that has not been used by the end of the plan year. This rule, known as the “use it or lose it” rule, provides that any amount remaining in a participant’s flex account at the end of the plan year cannot be carried over to future years or refunded to the participant. Although the rule permits such amounts to be divided among all participants, the great majority of plans provide for unused balances to simply be forfeited.

Under the newly announced rule, contained in IRS Notice 2005-42, a flex plan may provide a grace period of up to 2½ months after the end of the plan year during which participants may incur additional expenses to use up their remaining account balance. However, the balance still cannot be refunded to the participant, and any amount remaining at the end of the grace period must still be forfeited. If the participant continues to participate in the new year, any expenses that are incurred during the grace period are treated as reimbursed first out of the remaining account balance from the prior year. The grace period can be incorporated into either a medical or dependent care FSA, but as under current law the balance in a medical flex account cannot be used for dependent care expenses or vice versa.

The grace period is not automatic. FSA plans must be amended before the end of the plan year in order to provide a grace period. The IRS also announced that the regulations governing flex plans will be amended to provide more guidance on the grace period. Employers whose plans have a December 31 year end may wish to wait until more guidance is available before adopting an amendment, but employers whose plan years end soon will need to act quickly if they wish to permit the grace period for the current year. For example, a flex plan with a May 31 plan year end would need to be amended by the end of the current month to provide the grace period.

If you have any questions concerning this change in the rule, please contact the Seyfarth Shaw LLP Employee Benefits Group attorney with whom you work or any Employee Benefits attorney on the website at www.seyfarth.com.