



SPECIAL Alert

In This Issue

In this Special Alert, we will discuss the modification of Section 125 by IRS Notice 2005-42. This modification allows employers to add a grace period to their flexible spending account plans. The grace period would extend the timeframe to incur an eligible claim under the plan.

This alert will discuss the contents of the IRS Notice and its potential impact on employers and their flexible spending account plans.

We welcome your comments and suggestions regarding this issue. For more information on this article, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

“Change in Section 125”

The Internal Revenue Service (IRS) recently released [Notice 2005-42](#) which modifies Section 125. The modification allows employers to offer a “grace period” under their Medical Flexible Spending Accounts and Dependent Care Flexible Spending Accounts. The grace period extends the time for an individual to incur a service that would be considered a covered expense under the reimbursement plan.



This Special Alert discusses the IRS guidance and provides recommendations for adopting a grace period in your organization’s Section 125 plan.

IRS Notice 2005-42

The notice discusses the current Section 125 provisions that limit the time period for *incurring* claims for spending accounts to the 12 months of the plan year. It further discusses that Section 125 requires that a cafeteria plan cannot include a plan that offers a benefit that defers the receipt of compensation to the following plan year.

For medical and dependent care flexible spending accounts, this means a plan cannot allow contributions collected in one plan year to pay for a benefit incurred in the subsequent plan year. Consequently, organiza-

tions have structured their programs to require that a claim be incurred in the plan year in order to be considered a reimbursable expense under the plan.

Many plans also include a “claim time filing limit” that may allow a participant to file a claim within 60 or 90 days following the end of the plan year. However, for that claim to be considered an eligible expense, it must have been incurred within the plan year.

Currently, flexible spending account participants are required to use their annual elections for benefits incurred during the plan year or lose any funds that remain in the account at the end of the plan year. This constraint is commonly referred to as the “use it or lose it” rule.

In determining if a grace period provision is appropriate, this notice refers to the logic presented in other areas of tax law that allows for a short, limited period where compensation for services received in the following year is not considered deferred compensation by the IRS. One section of the Treasury regulations state that a plan shall not be consid-

ered deferring compensation or benefits, if the compensation or benefit is received in a brief period after the close of the employer's tax year. The brief period is defined as no later than the 15th day of the third month following the close of the employer's tax year.

The IRS and Treasury Department believe it is appropriate to modify the deferred compensation provisions of Section 125 to allow for a two and a half month grace period for incurring claims following the close of the plan year.

What Does This Mean for Employers?

Employers may add the two and a half month grace period to their FSA plan, extending the time an individual can incur an eligible claim. Any claim incurred during the two and a half month grace period would count toward any funds that remained in the spending account from the previous year. This would reduce the risk of losing year-end account balances as the result of the "use it or lose it" rule.

This may complicate the administration of flexible spending accounts a bit, but it may also encourage more employees to participate in the plan because it mitigates the impact of the "use it or lose it" rule.

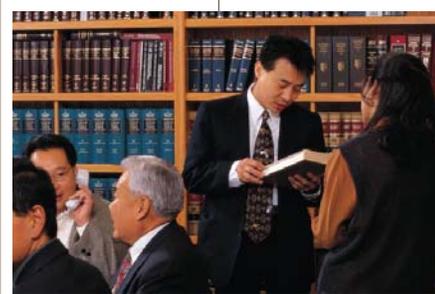
The following example illustrates the potential impact of this modification:

ABC Company offers a medical flexible spending account. The plan runs on a calendar year basis and the maximum contribution to the account is \$2,000. ABC Company added the two and a half month grace period to their plan.

Joe Smith, an employee at ABC, elected to set \$1,000 aside in the medical flexible spending account for 2006. By December 31, 2006, Joe had only used \$800 of his 2006 election. For 2007, he elected to set aside another \$1,000.

On January 25, Joe is hospitalized and incurs \$400 in unreimbursed medical expenses. With the new claim incurral grace period in place, \$200 can be reimbursed from the previous 2006 election and the remaining \$200 may be reimbursed from the new 2007 election. His remaining benefit for 2007 would be \$800.

*If ABC had **not** added the claim incurral grace period to their plan; Joe would have forfeited the \$200 remaining in his account at the end of 2006. The expenses incurred in January would be reimbursed from his 2007 election and he would have \$600 of remaining benefit for 2007.*



Action Steps

Adding a grace period to a Section 125 plan is not required. Employers have the option to choose to adopt this provision.

1. Employers need to review their Section 125 plans to determine if they want to add the grace period to their plan. Organizations should consider:

- **History of Forfeitures:** If an organization has historically had significant

forfeitures under the plan, adding a grace period should reduce the amount of forfeitures. If forfeitures were used to offset plan expenses an employer may not want to add the grace period. Adding the grace period will undoubtedly reduce forfeitures and ultimately increase the employer's administrative expense. Fewer forfeitures will offset less of the administrative expense.

- **Participation Rate:**

Organizations should also review the historical participation in the spending account plans. The "use it or lose it rule" frequently dissuades

individuals from participating in the plan. If the time period for determining an eligible claim is increased by two and a half months,

more employees may opt to participate in the plan.

- **Administrator Capabilities:**

If an organization is interested in adding the grace period, they should check with the plan administrator to make sure their claim system can be set up to recognize claims incurred in the grace period as eligible expenses under the previous plan year.

2. If an employer chooses to add a grace period to their spending account plan, the

Continued on Page 3

first step will be to determine what the grace period limit should be and amend the plan document accordingly. In order to allow a grace period, the provision must be outlined within the scope of the plan document. The guidance does not include an effective date. Therefore, a plan can determine an effective date and include it in the plan amendment.

However, the grace period cannot be added retroactively to apply to a plan year that has already ended. The effective date must be prospective.

If an employer decides to add a grace period for the 2005 plan year, the amendment must be made prior to the end of the plan year to apply. If the plan year was on a calendar year basis, the amendment must be made by December 31, 2005 to apply to the 2005 year.

3. In addition, organizations may also want to review their time filing limit for claim submission (typically the limit is 60 or 90 days). If the limit is measured from the close of the plan year and is only 60 days, this provision would conflict with a two and a half month grace period. Therefore, employers may want to amend their time filing limit to 30 days following the end of the grace period. The following is an example of how this would work:

- ABC Company's medical flexible spending account

has a January 1-December 31 plan year. There is a two and a half month grace period for incurring eligible expenses and a 30 day (one month) time limit for filing claims at the end



of the grace period. If Joe Smith elected \$1,000 for the medical FSA in 2005, he has until March 15, 2006 to

incur \$1,000 worth of eligible expenses. He also has until April 15, 2006 to submit eligible claims for reimbursement.

Important Note: Remember, plans cannot close their Section 125 plan financial records until the claim time filing limit is complete. Therefore, a plan would not want to add a two and a half month grace period and then allow a 90 day time filing limit from the end of the grace period. For a calendar year plan, plan records would not be closed until the middle of

June. It makes more sense to shorten the time filing limits and measure it from the end of the grace period.

The two and a half month permitted grace period is an outer limit; employers could adopt a shorter grace period (for example, 2 months). However, the grace period cannot extend any longer than two and a half months and meet IRS requirements.

If you have any questions, please feel free to contact your McGraw Wentworth Account Manager. **MW**

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