

**IRS ALLOWS MORE FLEXIBILITY IN FLEXIBLE SPENDING ACCOUNTS**

Yesterday (May 18, 2005) the Internal Revenue Service issued an important ruling that will benefit employees who participate in flexible spending account plans (FSAs). As you probably know, FSAs are accounts, usually funded by employee contributions under a cafeteria plan, which employees can use to pay health or dependent care expenses on a pre-tax basis. For example, an employee could use a health FSA to pay, on a pre-tax basis, deductibles, co-payments and other health expenses not paid by health insurance.

The most notable disadvantage of FSAs is the "use it or lose it" rule. Prior to yesterday's ruling, this rule provided that an employee would forfeit any unused amount left in a flexible spending account at the end of the plan year. Thus, the "use it or lose it" rule required that employees carefully plan how much they would contribute to FSAs for a plan year, because they would lose any "over-contribution".

In Notice 2005-42 (May 18, 2005), the IRS amended the "use it or lose it" rule to provide that an FSA plan may give employees a two and one-half month grace period after the end of each plan year during which the unused portion of their FSAs can be used to pay qualifying expenses. For example, in a calendar year FSA plan, employees could now have until March 15th of the following plan year in which to "spend" the full amount in their FSAs, rather than until (as under prior law) December 31<sup>st</sup> of the current plan year.

In order to take advantage of this new rule, an employer would have to amend its FSA plan document before the end of the plan year. Employers are not required to adopt this new rule.

**If you have any questions about this ruling or would like to amend your FSA plan, please contact a member of our Employee Benefits Practice group:**

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