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On May 18, 2005, the IRS issued Notice 2005-42 modifying the "use it or lose it" rule that applies to medical expense reimbursement plans and dependent care assistance plans. Employers can increase the value of their flex plans to employees with a cafeteria plan amendment that adopts this new rule.

Many employers offer medical flexible spending accounts and/or dependent care assistance programs as part of their cafeteria plans. "Medical FSAs" and "DCAPs" permit employees to contribute pre-tax dollars to the plan to be reimbursed for medical expenses or dependent care expenses, respectively, incurred throughout the plan year.

In recent years, the IRS has created additional types of tax-advantaged medical accounts that have permitted available amounts to be rolled over from plan year to plan year, while medical FSAs (and DCAPs) have continued to require that unused amounts be forfeited to the employer annually.

Under the new rule, the IRS will permit employers to amend their cafeteria plans to provide for a "grace period" of up to 2½ months after the end of the plan year, meaning that medical or dependent care expenses incurred during the grace period may be reimbursed from contributions remaining at the end of the just-completed plan year. Important criteria for this change include the application of the grace period to all participants in the plan, and use of contributions only for their intended purpose (without cash-out or conversion to any other taxable or nontaxable benefit), and forfeiture of amounts not used for expenses through the end of the grace period. Thus, if an employee has unused contributions at the end of the plan year in his or her medical FSA, the unused contributions may only be used for qualifying medical expenses incurred during the grace period.

The grace period is to the employees' advantage, as it is less likely to result in the forfeiture of unused contributions to employers. Employers considering incorporating the grace period must weigh this employee advantage against the employer's disadvantages of less in forfeitures to offset excess reimbursements to terminating employees and possibly even greater administrative costs.

Please contact our Benefits Law Group if you would like assistance in

amending your company's cafeteria plan to include the new grace period.

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