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Re: New IRS "Use-It-Or-Lose-It" Cafeteria Plan Rule

Dear Clients and Other Friends:

On May 18, 2005, the IRS announced an important and unexpected change to the "use-it-or-lose-it" rule for Internal Revenue Code §125 ("cafeteria") plans.

Under a cafeteria plan, participants elect to contribute pre-tax dollars toward the purchase of qualified benefits offered under the plan, such as health coverage and health or dependent care flexible spending accounts. Participants who contribute to flexible spending accounts may be reimbursed on a pre-tax basis for qualified expenses they incur during the plan year, up to the amount of their contributions. Currently, if a participant does not incur enough expenses during the plan year, the participant will forfeit any remaining balance in the account. This "use-it-or-lose-it" rule is intended to prevent the cafeteria plan from providing deferred compensation, i.e., from allowing participants to defer the receipt of income into later plan years.

In Notice 2005-42, the IRS changed the "use-it-or-lose-it" rule to allow plans a short grace period after a plan year during which expenses could be incurred and paid for as if they were incurred during that plan year. Under this new rule, compensation is not considered deferred if the unused benefits or contributions are used to pay expenses incurred within 2 ½ months after the end of the plan year. This gives participants up to 14 ½ months to incur expenses that can be reimbursed from the plan. So, for example, a participant who had a balance of \$500 in his or her health care spending account as of December 31, 2005 and incurred \$500 worth of medical expenses in February 2006 of the next year could be reimbursed from the 2005 health care spending account for those 2006 expenses, rather than forfeiting the balance under the "use-it-or-lose-it" rule.

In order to take advantage of this more generous rule for a plan year, a plan sponsor must amend its cafeteria plan document before the end of that plan year. Calendar year plans, then, will need to be amended by December 31, 2005, in order to allow participants to pay expenses incurred prior to March 15, 2006, with 2005 contributions. If a plan is not amended, the old rules will apply and only expenses incurred during the actual plan year may be reimbursed.

This new definition could reduce forfeitures and encourage participation in cafeteria plans by enlarging the window for reimbursable expenses. It will create some administrative

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challenges, though, since plans using the grace period will need to make sure that submitted expenses are attributed to the correct plan year. Sponsors may also need to adjust their “run-out” period, i.e., the period during which requests for reimbursement of timely incurred expenses may be submitted, in order to properly coordinate with the new grace period rule.

If you have any questions on this change in the rules, or would like our help in amending your plan to take advantage of the new grace period, please let us know.

Very truly yours,

Sonja Lemmer Martens

SLM/hgn