



The Vita Viewpoint Important Information for Decision Makers

Section 125 – “Quasi” Rollover Allowed

Background

The Treasury Department and IRS published Notice 2005-42 on May 18, 2005 which modifies the rule prohibiting deferred compensation under a Section 125 Cafeteria Plan. The IRS promulgated a very long and complex rationalization about the deferred compensation rules to justify this regulatory change. Effectively, this ruling will provide employers with the ability to modify the long-held “Use-It-or-Lose-It” rule.

What it Really Means

Under the new ruling, employers may elect to amend their Plans to adopt a “grace period” for incurring claims after the end of the Plan Year. If an employer elects to adopt this provision, participants would be allowed to incur expenses during the grace period. The maximum grace period would be the 15th day of the third month after the Plan Year closes (2½ months). Any expenses incurred in the 2½ month grace period could be used to receive reimbursement for any unused balance from the prior Plan Year. This change creates a “quasi” rollover feature. However, ultimately, participants would still be subject to the old “Use-It-or-Lose-It” rule after the 2½ month grace period has expired. This change would effectively allow participants 14½ months to incur expenses for each Plan Year.

Example

Steve Jones has elected \$1,000 in a Health FSA through NetNumbers, Inc. for the 2005 Plan Year. As of January 1, 2006, Steve has an unused balance of \$250 from his \$1,000 original election for the 2005 Plan Year. Steve and his wife Mary buy \$100 worth of eligible Over-the-Counter drug expenses on March 15, 2006. He submits proper documentation for the claim and receives the \$100 reimbursement, but forfeits the \$150 that he did not use before March 16, 2006.

Timing

The IRS has indicated that plans may be amended to reflect this change for the 2005 Plan Year.

Commentary

While participants will certainly look to this change with favor, the IRS ruling was written in a permissive manner, not a prescriptive manner. Each Plan Sponsor will need to individually make a decision whether or not to adopt this newly allowed grace period in their Plan. Vita Administration Company will be working with Plan Sponsors individually to discuss the pros and cons of implementing this provision for the 2005 Plan Year. At first glance, we foresee delayed procrastination among participants in incurring expenses and potential confusion for Plan participants when making their prospective election for the upcoming Plan Year.

For questions or additional information, please contact Vita Benefits Group at (650) 968-8811.