

BENEFITS ALERT 2005-9

To	All Clients & Friends of FBMC	Date	12/02/2005
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Re	Revenue Notice 2005-86 HSA Eligibility During Health FSA Grace Period		

Following the establishment of a new grace period under IRS Notice 2005-42 (see FBMC Benefits Alert 2005-3), the Treasury and IRS issued **IRS Notice 2005-86** on November 22, 2005. This recent Notice presents a new option to cafeteria plan sponsors on how to make a health FSA plan that reimburses *all qualified medical expenses under Code § 213(d)* (sometimes called a “general-purpose” health FSA plan) become HSA-compatible during the plan’s grace period. Additionally, the Notice provides transitional relief and clarifies some of the grace period guidance in IRS Notice 2005-42.

For a copy of the Treasury’s press release: <http://www.treas.gov/press/releases/js3022.htm>.

For a copy of IRS Notice 2005-86: <http://www.treas.gov/press/releases/reports/n0586.pdf>.

Complication Under IRS Notice 2005-42. With the issuance of IRS Notice 2005-42, many plan sponsors amended (or are in the process of amending) their cafeteria plan documents to establish a grace period for certain of their qualified benefits, including their health FSA and/or dependent care FSA plans.

Cafeteria plan sponsors establishing a grace period for their *general-purpose* health FSA plans quickly realized that plan participants (and their spouses if their expenses were also eligible for reimbursement under the plan) could not contribute to an HSA until the 1st day of the 1st month following the end of the plan’s grace period. It didn’t matter if the general-purpose health FSA participants had used up the funds in their accounts before the end of the plan year or even during the plan’s grace period. The significance of being able to establish a grace period for general-purpose health plans was somewhat tempered by the lack of an IRS-approved option to make those plans HSA-compatible during the plan’s grace period.

Remember that in order for an individual to be eligible to contribute to an HSA, he or she must be covered by a high deductible health plan (HDHP) and generally no other non-HDHP coverage, *including participation in a general-purpose health FSA*.

Using the 2005 calendar plan year, if general-purpose health FSA plan participants (and their spouses if their expenses are also covered under the plan) are to be covered during a grace period that extends up to the IRS maximum of March 15, 2006 (i.e., the 15th day of the 3rd calendar month following the end of a plan year), they must wait until April 1, 2006 to become eligible to contribute 9/12th of the 2006 contribution limits to an HSA.

New Option! Recognizing this dilemma, IRS Notice 2005-86 expands on the guidance in earlier Notices to provide an alternative so that a *general-purpose* health FSA plan can also become HSA-compatible if the cafeteria plan document is amended to provide for an automatic, **mandatory conversion** of the general-purpose health FSA to a limited-purpose health FSA, a post-deductible health FSA, or

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a combination of both. This new plan design option must satisfy all of the other requirements of IRS Notice 2005-42. Because it provides for the mandatory conversion of the general-purpose health FSA, individual participants will not be permitted to elect between an HSA-compatible FSA or an FSA that is not HSA-compatible. It must apply to the plan's entire grace period and to **all** participants in the health FSA who are covered by the grace period, *whether or not they had elected HDHP coverage, or enrolled in a non-qualifying low deductible health plan.*

Transition Relief. In addition to the general guidance in this Notice, plan sponsors whose cafeteria plans end *on or before June 5, 2006*, can amend their cafeteria plan documents to enable individuals, participating in a general-purpose health FSA with a grace period, to be eligible to contribute to an HSA during the grace period *if they are otherwise eligible to make HSA contributions and* (i) either have no unused funds to carry over to the plan's grace period, or (ii) the plan sponsor further amends its cafeteria plan document to exclude participants from the grace period if they enroll in HDHP coverage during the grace period (provided they are not covered under their spouse's employer's general-purpose health FSA plan).

For *calendar* plan year sponsors who have already finalized their 2006 plan year designs as well as completed their open enrollment periods, this transitional relief has probably come too late in the year.

IRS Notice 2005-86 Clarifies Grace Period Administration.

- Once established, a plan's grace period will remain in effect for the entire period *even for participants who terminate employment prior to the end of the grace period.* However, for applicable benefit plans, COBRA continuation coverage does not have to be offered to participants who terminate employment before the end of the plan's grace period though they may be COBRA-eligible under the benefit plan for the *current* plan year.
- A plan's grace period can be shorter but it cannot extend beyond the IRS maximum, which is the 15th day of the 3rd calendar month following the end of the plan year to which the grace period applies.
- A plan's grace period must be made available to all of the benefit plan's active participants *and* qualified beneficiaries receiving COBRA (if applicable to the benefit plan) if they are covered under the plan on the last day of the plan year. It is not available to a participant or qualified beneficiary whose plan coverage ended *prior* to the last day of the plan year.
- A cafeteria plan sponsor may limit the application of the grace period to only certain qualified benefits. For example, it can establish a grace period for its health FSA plan but not its dependent care FSA plan.

Additional Information

Please contact your Account Manager or the undersigned.