

Health Savings Account Eligibility During A Cafeteria Plan Grace Period

Part III - Administrative, Procedural, and Miscellaneous

Notice 2005-86

PURPOSE

This notice provides guidance on eligibility to contribute to a Health Savings Account (HSA) during a cafeteria plan grace period as described in Notice 2005-42, 2005-23 I.R.B. 1204. As discussed below, an individual participating in a health flexible spending arrangement (health FSA) who is covered by the grace period is generally not eligible to contribute to an HSA until the first day of the first month following the end of the grace period, even if the participant's health FSA has no unused benefits at the end of the prior cafeteria plan year. This notice, however, provides guidance on how an employer may amend the cafeteria plan document to enable a health FSA participant to become HSA eligible during the grace period.

BACKGROUND

Cafeteria Plans

Section 125(a) states that, in general, no amount is included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant

may choose among the benefits of the plan. Section 125(d) defines a cafeteria plan as a written plan under which all participants are employees, and the participants may choose among two or more benefits consisting of cash and qualified benefits. “Qualified benefits” mean any benefit which, with the application of § 125(a), is not includible in the gross income of the employee by reason of an express provision of Chapter 1 of the Internal Revenue Code, including employer-provided accident and health coverage under §§ 106 and 105(b). A high deductible health plan (HDHP) as defined in § 223(c)(2)(A) can be employer-provided accident and health coverage. A health FSA, which pays or reimburses certain § 213(d) medical expenses (other than health insurance or long-term care services or insurance), is also employer-provided accident and health coverage. The term “qualified medical expenses” as used in this Notice, means expenses which may be paid or reimbursed under a health FSA.

Cafeteria Plan Grace Period

Notice 2005-42, 2005-23 I.R.B. 1204, modifies the application of the rule prohibiting deferred compensation under a cafeteria plan (i.e., the “use-it-or-lose-it” rule). The notice permits a cafeteria plan to be amended, at the employer’s option, to provide a grace period immediately following the end of each plan year, during which an individual who incurs expenses for a qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions relating to that benefit. A plan providing a grace period

is required to provide the grace period to all participants who are covered on the last day of the plan year (including participants whose coverage is extended to the last day of the plan year through COBRA continuation coverage). The grace period remains in effect for the entire period even though the participant may terminate employment on or before the last day of the grace period. But an employer may limit the availability of the grace period to only certain cafeteria plan benefits and not others. For example, a cafeteria plan offering both a health FSA and a dependent care FSA may limit the grace period to the health FSA. The grace period must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates, but may be adopted for a shorter period.

Interaction Between HSAs and Health FSAs

Section 223(a) allows a deduction for contributions to an HSA for an "eligible individual" for any month during the taxable year. An "eligible individual" is defined in § 223(c)(1)(A) and means, in general, with respect to any month, any individual who is covered under an HDHP on the first day of such month and is not, while covered under an HDHP, "covered under any health plan which is not a high-deductible health plan, and which provides coverage for any benefit which is covered under the high-deductible health plan."

In addition to coverage under an HDHP, § 223(c)(1)(B) provides that an eligible

individual may have disregarded coverage, including “permitted insurance” and “permitted coverage.” Section 223(c)(2)(C) also provides a safe harbor for the absence of a preventive care deductible. See Notice 2004-23, 2004-1 C.B. 725. Therefore, under § 223, an individual who is eligible to contribute to an HSA must be covered by a health plan that is an HDHP, and may also have permitted insurance, permitted coverage and preventive care, but no other coverage. A health FSA that reimburses all qualified § 213(d) medical expenses without other restrictions is a health plan that constitutes other coverage. Consequently, an individual who is covered by a health FSA that pays or reimburses all qualified medical expenses is not an eligible individual for purposes of making contributions to an HSA. This result is the same even if the individual is covered by a health FSA sponsored by a spouse’s employer.

However, as described in Rev. Rul. 2004-45, 2004-1 C.B. 971, an individual who is otherwise eligible for an HSA may be covered under specific types of health FSAs and remain eligible to contribute to an HSA. One arrangement is a limited-purpose health FSA, which pays or reimburses expenses only for preventive care and “permitted coverage” (e.g., dental care and vision care). Another HSA-compatible arrangement is a post-deductible health FSA, which pays or reimburses preventive care and for other qualified medical expenses only if incurred after the minimum annual deductible for the HDHP under § 223(c)(2)(A) is satisfied. This means that qualified medical expenses incurred before the HDHP deductible is satisfied may not be reimbursed by a post-deductible HDHP

even after the HDHP deductible had been satisfied. To summarize, an otherwise HSA eligible individual will remain eligible if covered under a limited-purpose health FSA or a post-deductible FSA, or a combination of both.

OPTIONS AVAILABLE TO AN EMPLOYER

An employer may adopt either of the following two options, which will affect participants' HSA eligibility during the cafeteria plan grace period:

(1) General Purpose Health FSA During Grace Period

Employer amends the cafeteria plan document to provide a grace period but takes no other action with respect to the general purpose health FSA. Because a health FSA that pays or reimburses all qualified medical expenses constitutes impermissible "other coverage" for HSA eligibility purposes, an individual who participated in the health FSA (or a spouse whose medical expenses are eligible for reimbursement under the health FSA) for the immediately preceding cafeteria plan year and who is covered by the grace period, is not eligible to contribute to an HSA until the first day of the first month following the end of the grace period. For example, if the health FSA grace period ends March 15, 2006, an individual who did not elect coverage by a general health FSA or other disqualifying coverage for 2006 is HSA eligible on April 1, 2006, and may contribute 9/12ths of the 2006 HSA contribution limit. The result is the same even if a participant's

health FSA has no unused contributions remaining at the end of the immediately preceding cafeteria plan year.

(2) Mandatory Conversion from Health FSA to HSA-compatible Health FSA for All Participants

Employer amends the cafeteria plan document to provide for both a grace period and a mandatory conversion of the general purpose health FSA to a limited-purpose or post-deductible FSA (or combined limited-purpose and post-deductible health FSA) during the grace period. The amendments do not permit an individual participant to elect between an HSA-compatible FSA or an FSA that is not HSA-compatible. The amendments apply to the entire grace period and to all participants in the health FSA who are covered by the grace period. The amendments must satisfy all other requirements of Notice 2005-42. Coverage of these participants by the HSA-compatible FSA during the grace period does not disqualify participants who are otherwise eligible individuals from contributing to an HSA during the grace period.

TRANSITION RELIEF

For cafeteria plan years ending before June 5, 2006, an individual participating in a general purpose health FSA that provides coverage during a grace period will be eligible to contribute to an HSA during the grace period if the

following requirements are met: (1) If not for the coverage under a general purpose health FSA described in clause (2), the individual would be an "eligible individual" as defined in § 223(c)(1)(A) during the grace period (in general, is covered under an HDHP and is not, while covered under an HDHP, covered under any impermissible other health coverage); and (2) Either (A) the individual's (and the individual's spouse's) general purpose health FSA has no unused contributions or benefits remaining at the end of the immediately preceding cafeteria plan year, or (B) in the case of an individual who is not covered during the grace period under a general purpose health FSA maintained by the employer of the individual's spouse, the individual's employer amends its cafeteria plan document to provide that the grace period does not provide coverage to an individual who elects HDHP coverage.

EFFECT ON OTHER DOCUMENTS

Notice 2005-42 and Rev. Rul. 2004-45 are amplified.

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Tanner of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Tanner on (202) 622-6080 (not a toll-free call).