

ALSTON + BIRD_{LLP}

CLIENT ADVISORY

11/28/05

HSA/FSA Grace Period Guidance Restricts Employer Options But Provides Limited Transition Relief

**By Ashley Gillihan, Esq. and John R. Hickman, Esq.
Alston & Bird, LLP© 2005**

On November 22, 2005, the IRS issued Notice 2005-86, which clarifies the impact of a Health FSA grace period on eligibility for an HSA. The Notice indicates that individuals participating in a Health FSA with a grace period are ineligible to establish and contribute to a Health Savings Account (HSA) until the first day of the first month following the end of the grace period, *even if the individual has no carry over funds or exhausts such funds prior to the end of grace period*. Thankfully, the Notice indicates that employers who wish to establish a grace period without disqualifying employees from HSA participation can amend their plans to convert coverage during the grace period to a limited purpose Health FSA (i.e., one covering only permitted vision, dental, or preventive care expenses), a post-deductible Health FSA, or combination of both for all participating employees. The Notice also provides transition relief for plans with plan years ending on or before June 5, 2006.

Below we set out the HSA eligibility issue raised by the grace period, the guidance provided under the new Notice and the steps that employer should take given this guidance. You can find a copy of Notice 2005-86 at <http://www.treas.gov/press/releases/reports/n0586.pdf>.

The Legal Dilemma

The grace period guidance, Notice 2005-42, indicates that employers can amend their cafeteria plans to allow account participants to carry over unused Health FSA amounts at the end of a plan year and use such funds for eligible expenses incurred during a “grace period”, which is a period extending no more than two months and 15 days beyond the end of the plan year. For example, assume that Joe’s employer adopts the full 2 ½ month grace period effective December 31, 2005. Joe has \$500 of unused funds in his Health FSA as of December 31, 2005 (the end of the 2005 plan year). With the grace period, Joe can use that \$500 for expenses incurred between January 1, 2006 and March 15, 2006.

Unfortunately, this FSA grace period has a disqualifying effect on HSA eligibility. An individual fails to qualify as an “eligible individual” (as defined in Code

Section 223(c)(1)) for purposes of establishing and making or receiving tax favored contributions to an HSA if he or she has non-qualifying high deductible health coverage that provides more than permitted coverage, preventive care and/or permitted insurance.¹ Since Health FSAs typically reimburse most Code Section 213(d) medical expenses and are not subject to a deductible, an individual covered by a Health FSA is typically ineligible to establish and/or contribute to an HSA with tax favored dollars. IRS clarified in Revenue Ruling 2004-45 several different types of Health FSA plan designs that will not disqualify an individual, including a limited purpose Health FSA, a post-deductible Health FSA (e.g., a health FSA that reimburses expenses incurred after the HDHP deductible has been satisfied) or a combination of both.

Up to this point, it was unclear how the grace period would affect eligibility for an HSA. For example, assume our exemplar, Joe, wants to enroll in his employer's HDHP effective January 1, 2006, and establish an HSA. Thus, Joe does not enroll in the general purpose Health FSA for 2006. Joe, however, has \$500 remaining in his 2005 health FSA that is subject to a 2 1/2 month grace period. Is Joe disqualified from establishing an HSA in 2006 by virtue of the \$500 carry over even though Joe did not elect to participate in the Health FSA in 2006? If so, is Joe disqualified until the first day of the month following the grace period or, if earlier, the date Joe has exhausted his carry over funds? Also, what if Joe has no carry over funds? Would the grace period coverage still affect his HSA eligibility?

Notice 2005-86 answers these questions and provides alternatives for plan sponsors. In addition, the Notice provides clarification regarding administration of the grace period.

The Guidance and Resolution of the Legal Dilemma

Impact of Grace Period on HSA Eligibility

Notice 2005-86 provides the following guidance with respect to the impact of grace periods on HSA eligibility.

- § ***Grace period negates HSA eligibility until the “end” of the grace period.*** An individual “covered” by a grace period is not eligible to enroll in an HSA until the first day of the month following the end of the grace period, even if the individual has no carry over funds or exhausts funds prior to the end of the grace period. In other words, if an employee participates in a plan that has adopted a grace period, and the employee is a participant or qualified beneficiary on the last day of the Plan Year, the employee is considered “covered” under a Health FSA until the end of the grace period without regard to whether any additional expenses can be reimbursed. Consider Joe, from our example above. He carried over \$500 to be used during the grace period; therefore, he is not eligible to establish an HSA until April 1, 2006. What if Joe had no carry over amount from the 2005 plan year? The result would be the same; he would not be eligible to establish an HSA until

¹ See Revenue Ruling 2004-45 and Revenue Ruling 2004-38.

April 1, 2006. What if he had spent his \$500 for expenses incurred on January 31, 2006? Again, Joe would not be eligible to establish an HSA until April 1, 2006.

§ ***Employers can convert general purpose FSA grace period to limited purpose FSA grace period for all participants to allow HSA eligibility.*** Fortunately, Treasury indicates in the Notice that the employer may convert coverage during the grace period for all covered individuals to a permitted plan design, including a limited purpose Health FSA, a post-deductible Health FSA (i.e., an FSA that reimburses expenses incurred after the HDHP deductible has been satisfied) or a combination of both. However, there are a few nuances to consider:

- This conversion cannot be elective. If adopted, it is “mandatory” for all participants in the Plan. Participants cannot individually elect to restrict coverage during the grace period. The Health FSA is automatically converted for all participants by plan design. Although this guidance relates only to the grace period, it would seem if an employer introduces an HSA option mid-year, the principles established by the guidance dictate that an employer could make a mid-year conversion of the Health FSA (e.g., to a limited-purpose FSA) for all participants in the Health FSA (not just those that want to contribute to an HSA), but that a voluntary election to change the scope of coverage by only those who elect HDHP coverage is not permitted. The introduction of a new benefit, such as an HSA, mid-year, is not an event that would allow employees to change their Health FSA elections. IRS had previously informally indicated that a participant enrolling in an HDHP mid year could elect to limit the scope of coverage under the FSA without violating the Code Section 125 election change rules so long as the salary reduction amount was not changed; however, if such a voluntary election is not allowed for a grace period, it may not be permissible during the year either. Thus, unless the employer converts the entire FSA mid-year to an HSA-compatible FSA upon a mid-year introduction of an HSA, employees participating in the FSA would be ineligible for the HSA until the first day of the first month following the date that coverage ceases under the Health FSA for the year (which would be the earlier of the date they ceased to be a participant or, the end of the grace period, if applicable).
- The conversion applies to all Health FSA participants whether they elect qualifying HDHP coverage or not (this assumes that the employer offers one general purpose health FSA to all employees). Thus, employers who offer a non-qualifying low deductible as well as an HDHP option should note that the conversion will apply to all Health FSA participants.

Additional Guidance for Post-Deductible Health FSAs (and HRAs)

The Notice clarifies that if you have a post-deductible Health FSA (i.e. one that pays general purpose expenses after the HDHP deductible has been satisfied), only those general medical expenses incurred *after* the deductible has been satisfied may be reimbursed. Thus, the guidance suggests you cannot “pend” general medical expenses incurred before the HDHP deductible has been satisfied and then reimburse them after the deductible has been satisfied. We wonder if this is the intended result. Consider the following example to illustrate the result of this interpretation:

Joe’s employer offers an HDHP and a Health FSA that are considered part of the same health plan. Joe’s employer amends the Health FSA to convert it to a post-deductible Health FSA that will only reimburse general medical expenses incurred after the HDHP deductible has been satisfied. Joe, who is single, has single HDHP coverage with a \$1050 deductible. Joe incurs a \$500 “deductible” expense on February 20, 2006, a \$300 deductible expense on March 15, and a \$250 deductible expense on April 25. Thus, he satisfies his HDHP deductible on April 25, 2006. In addition, Joe incurs \$250 in over the counter expenses on March 25, 2006.

Reading the guidance literally, Joe could only receive reimbursement for expenses incurred after April 25, 2006, the date he satisfies his HDHP deductible. Thus, Joe has to actually incur \$1300 in expenses before he can receive reimbursement for general medical expenses from the Health FSA. Rev. Rul. 2004-45 clarified that the Health FSA (or HRA) could have a separate deductible so long as it satisfies the minimum statutory deductible requirements of Code Section 223. If you assume that “deductible” expenses and the over the counter expenses apply toward the Health FSA deductible, it would seem permissible for Joe to begin receiving reimbursement for eligible expenses incurred after he incurred \$1050 in expenses, which was March 25, 2006. In this example, no plan or arrangement pays Joe’s general medical expenses until he has incurred \$1050 in out of pocket medical expenses, which satisfies the minimum statutory deductible requirements under Code Section 223. Additional guidance from IRS clarifying its intent in this matter would be welcomed.

Also, the Notice does not clarify how an individual with additional family members under a Health FSA is treated for HSA eligibility and contribution purposes. More specifically, to which deductible, single or family HDHP coverage for example, is a post-deductible HSA tied? While Rev. Rul. 2004-45 clarifies that a Health FSA that pays general medical expenses incurred after the HDHP deductible is satisfied will not adversely affect HSA eligibility, it also states that the post deductible Health FSA must satisfy the statutory minimum deductible rules. Consider the following. Assume that Joe has single coverage under the HDHP with a \$1050 deductible and a post-deductible FSA that covers Joe, his spouse and his children. Per Rev. Rul. 2004-45, the Health FSA must satisfy the statutory minimum deductible. Because the Health FSA is technically “family” coverage; the Health FSA cannot pay anything other than dental, vision, and preventive care below the statutory minimum deductible for family coverage, which is \$2100 for

2006. Thus, it would appear that Joe is disqualified from establishing and contributing to an HSA until the family deductible is met. The guidance doesn't specifically address this situation.

Note that these issues apply equally to post deductible HRAs.

Administration of the Grace Period

Notice 2005-86 also provides helpful clarification regarding grace period administration:

- § A plan must make the grace period available to *all* individuals who, on the last day of the Plan Year, are covered under the plan as active participants or as qualified beneficiaries receiving COBRA continuation coverage. Thus, the grace period must be offered not only to active employees participating in the plan and former employees receiving COBRA coverage in the plan on the last day of the year, but also qualified beneficiary ex-spouses and former dependent children who made a COBRA election and were receiving coverage on the last day of the year. It is not available to any employee or qualified beneficiary whose coverage ends prior to the last day of the plan year.
- § The grace period remains in effect until the end of the period adopted by the employer (not to exceed 2 ½ months following the end of the plan year), *even if the employee terminates employment before the end of the grace period*. This means that COBRA continuation of the grace period coverage does not have to be offered to those who terminate employment before the end of the grace period. That being said, such employees may be eligible to elect COBRA continuation of current year coverage depending on the Health FSA's status as an excepted benefit and the employee's account balance as of the date of termination.
- § Employers may choose to apply the grace period to one benefit but not another (e.g. employers may amend the Health FSA to add the grace period but not the dependent care FSA). That being said, whichever benefit the employer amends to add the grace period, the plan sponsor must make the grace period available to all participants in that plan and qualified beneficiaries receiving coverage under that plan on the last day of the plan year. That being said, it appears that the employer may be able to establish separate health FSA plans to accomplish different goals.

Obviously, at some point administrative concerns constrain such plan design "options."

Transition Relief

Fortunately, the Notice provides transition relief for certain individuals. For plan years ending on or before June 5, 2006, individuals who are eligible individuals but for coverage provided during the grace period (other than limited purpose or otherwise permitted FSA coverage) may establish an HSA and make or receive tax favored

contributions so long as the individual had no carry over funds or, *if the individual is not covered under a general purpose Health FSA maintained by the spouse's employer*, the employer amends the plan to exclude individuals who enroll in an HDHP from the grace period.² Note that the ability to exclude participants from the grace period if they enroll in an HDHP is a transition period option only. After the transition period, this approach will violate the rule that the grace period be made available to *all* participants and qualified beneficiaries covered under the Health FSA on the last day of the plan year.

Interestingly, no transition relief was provided for those already in a grace period (e.g. for non-calendar year plans that have ended prior to this Notice) where funds were carried over into the grace period. Plans beginning before this Notice that adopted a grace period must make adjustments to their plans in accordance with this guidance.

Plan of Action

Plan sponsors and administrators who have adopted a grace period and plan to offer an HDHP and the ability to establish an HSA in 2006 may need to revisit their decision to offer a grace period. If plan sponsors wish to offer a grace period, then some fine-tuning consistent with this guidance may be required. In most cases they will need to further amend the plan to automatically convert the coverage during the grace period to otherwise permissible Health FSA coverage.

Also, plan sponsors who wish to offer a post-deductible Health FSA that pays expenses incurred after the HDHP deductible is satisfied should consider the issues discussed above.

² The italicized language is part of a revised Notice 2005-86 issued by Treasury subsequent to the original Notice 2005-86. Presumably, the language was added to clarify that an individual who is covered under a spouse's employer's general purpose health FSA is not eligible for transition relief; however, we note that the original version, and the revised version, both conditioned eligibility for transition relief on being an otherwise eligible individual but for the grace period. Thus, even under the original Notice, an individual covered under a spouse's employer's general purpose Health FSA would not be eligible for transition relief.