



Health Savings Account Eligibility During a Cafeteria Plan Grace Period

Fast Facts

- Health FSAs that allow participants to extend their period of coverage into the next plan year may keep HSA participants from being able to fund their HSA
- Employers who have amended their plan to include the new 2-1/2 month “grace” period may:
 - Choose not to further amend their plan document. Participants are simply not eligible to contribute to their HSA until the first day of the first month following the end of the grace period; or
 - Amend their plan document to provide a mandatory conversion of a general-purpose HFSA to a limited-purpose or post-deductible HFSA during the “grace” period. This means that individuals cannot choose between the general HFSA and the limited-purpose or post-deductible HFSA.

Employees who have taken steps to open a Health Savings Account (HSA) for 2006 may have to recalculate their eligible contributions for the 2006 calendar year.

The dilemma started in May, 2005 when the IRS set out rules for a “grace” period in which participants had 2-½ months during their new cafeteria plan year to spend left-over dollars from a previous plan year. Sounds great for those with leftover dollars, but raised additional questions about how the “grace” period coverage would affect new participants in an HSA.

IRS Notice 2005-86 clarifies how employers may handle this double coverage and allow participants in a high-deductible health plan (HDHP) to be eligible to contribute to their HSA through the cafeteria plan “grace” period.

HSA Background

To allow a deduction for contributions to an HSA, a participant must be an “eligible individual.” An eligible individual means someone who is covered under a qualifying HDHP on the first day of any month and is not covered by any other health plan which is not a HDHP, and which provides coverage for any benefit which is covered under the HDHP.

The Health Flexible Spending Account (HFSA) within a Section 125 cafeteria plan constitutes other health plan coverage. If a participant or their spouse is participating in a general-purpose HFSA they cannot make contributions to an HSA for the month they have HFSA coverage. Extending a participant’s period of coverage by implementing a “grace” period makes participants ineligible to contribute to an HSA during the “grace” period.

How can the employer that sponsors both an HSA and an HFSA facilitate the needs of HSA participants? The employer may amend their cafeteria plan document to allow for a limited-purpose HFSA or a post-deductible HFSA.

HSA Compatible Plans

- *Limited-purpose HFSA.* The HFSA is limited to payment of only permitted coverage items like vision, dental, and preventive care expenses – whether or not the HDHP’s minimum annual deductible has been met. This range of benefits does not breach the “no other insurance” rule of HSAs.
- *Post-deductible HFSA.* With this benefit, the HFSA is considered to be a high-deductible insurance product. HFSA reimbursements do not kick off until after the minimum deductible is met. Participant reimbursement from the HFSA doesn’t have to wait until the HDHP’s deductible amount is met, but the “minimum” deductible standard for HSAs must

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be met. The minimum annual deductible amount for 2006 is \$1,050 for single coverage and \$2,100 for family coverage.

Notice 2005-86 Clarification

Mandatory Conversion

The employer amends their cafeteria plan document to provide for the “grace” period and a mandatory conversion of the general-purpose HFSA to a limited-purpose or post-deductible HFSA during the “grace” period. The amendment does not permit an individual to determine whether to be covered by the general-purpose HFSA or the HSA-compatible HFSA. All participants are treated alike.

This forces all participants into a “one size fits all” HFSA. Funds left over from a previous year could only be used for vision, dental, and preventive care – even if the participant did not sign up for the HDHP and HSA coverage.

General-Purpose HFSA

The employer amends their cafeteria plan document to provide the “grace” period. No further action needs to be taken by the plan sponsor. Participants are simply not eligible to contribute to an HSA until the first day of the first month following the end of the grace period. Even if a participant ends the previous plan year with a zero balance, the grace period extends, and affords them impermissible coverage. They may not make a deductible contribution to their HSA until the month following the end of the grace period.

This seems to be the most sensible approach. HSA owners would only lose the ability to contribute to their HSA for three months. And this would be only for the first “transition” year. In subsequent years, the participant would elect not to have HFSA coverage or would elect into a limited-purpose HFSA or post-deductible HFSA.

Participants may establish their HSA, with a minimum deposit, at the beginning of the new cafeteria plan year. However, care must be taken to contribute only nine months of the annual HSA contribution limit.

Combination Plans

The employer may wish to create a combination of a limited-purpose and a post-deductible HFSA. For instance, the HFSA is treated as a limited-purpose HFSA until the specified deductible is met and thereafter as a post-deductible HFSA.

This approach may be too confusing for the participant who must make an irrevocable election to the HFSA, and faces losing unspent dollars.

Transitory Relief

Since most companies are well into, and possibly beyond, their enrollment period for the 2006 plan year, the IRS has offered some transition relief. For cafeteria plans ending before June 5, 2006, a participant in a general-purpose HFSA that provides coverage during a grace period will be eligible to contribute to an HSA during the grace period if all the following requirements are met:

- The participant would be eligible to contribute to an HSA if not for the coverage under the general-purpose HFSA, and
- Either the participant’s HFSA has no unused contributions or benefits remaining at the end of the previous plan year or the employer amends its cafeteria plan to provide that the grace period does not provide coverage to an individual who elects HDHP coverage.

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