



Electronic Dispatch

# Employee Benefits Law Action Memo

December 2005

[Go to BS&K Employee Benefits Home Page](#)

## IRS ISSUES GUIDANCE REGARDING THE IMPACT OF FSA GRACE PERIODS ON HSA ELIGIBILITY, DEFERRED COMPENSATION REPORTING AND WITHHOLDING, AND PLAN AMENDMENT DEADLINE

In separate Notices, the Internal Revenue Service ("IRS") recently announced three items of particular interest to employee benefit plan sponsors and administrators. The items relate to:

- FSA Grace Periods and HSA Eligibility. In Notice 2005-86, the IRS confirmed that an otherwise eligible individual generally will not be able to contribute to a health savings account ("HSA") if the individual is covered by a general-purpose flexible spending account ("FSA") during the "grace period" that may now be added to FSAs.
- Deferred Compensation Reporting and Withholding. In Notice 2005-94, the IRS suspended, for calendar year 2005, the reporting and withholding requirements that apply to non-qualified deferred compensation arrangements under new Internal Revenue Code Section 409A.
- Cash-Out/Rollover Amendment Deadline. In Notice 2005-95, the IRS extended the deadline for employers to amend their tax-qualified retirement plans to reflect plan practices with respect to mandatory cash-outs and automatic rollovers. The deadline has been extended to the later of December 31, 2005, the last day of the plan year that includes March 28, 2005, or the deadline (including extensions) for filing the employer's income tax return for its taxable year that includes March 28, 2005.

Additional details are provided below.

### Impact of FSA Grace Periods on HSA Eligibility.

Earlier in 2005, the IRS modified the "use it or lose it" rule that generally applies to FSAs. Employers may now amend FSAs to allow covered employees to carry over unused FSA contributions from one FSA plan year and use those unused contributions for covered claims incurred during a grace period (of up to 2½ months) at the beginning of the next plan year.

At the time the grace period authorization was announced, it was unclear how an individual's ability to receive FSA reimbursements during the grace period would affect that individual's eligibility to contribute to an HSA. In Notice 2005-86, the IRS has confirmed that an individual who is covered by a general-purpose health FSA that has a grace period will not be eligible to contribute to the individual's HSA during the grace period. The individual will not be permitted to make contributions to the HSA until the first day of the month that follows the end of the grace period. No contributions may be made to the HSA, even if the individual had no excess carry-over contributions in the grace period or has exhausted his or her available grace period reimbursements under the FSA.

Fortunately, the IRS provided some transition relief. For plan years that end before June 5, 2006, a participant in a general-purpose FSA may still qualify to contribute to an HSA during the grace period, if the individual has no unused carry-over contributions from the prior plan year, or the employer amends the FSA to provide that the grace period does not apply to individuals who elect HSA and high-deductible health plan coverage.



To help minimize the adverse impact of the IRS's recent guidance, employers that sponsor FSAs with grace periods also might consider grace periods of less than the full permitted 2½ months, thus allowing HSA contributions earlier than if the full 2½-month grace period is adopted. Further, because coverage under a "limited-purpose" HSA does not disqualify an individual from being eligible to contribute to an HSA, coverage under a "general-purpose" FSA that is automatically converted to a limited-purpose FSA during the grace period will not disqualify an otherwise eligible individual from making HSA contributions during the grace period.

### **Suspension of Certain Deferred Compensation Reporting and Withholding Obligations.**

Under new Internal Revenue Code Section 409A, employers that provide non-qualified deferred compensation face a number of complex compliance requirements. Included in those requirements are reporting and withholding requirements that generally became effective as of January 1, 2005. In Notice 2005-94, the IRS suspended the reporting and withholding requirements for calendar year 2005. The IRS Notice provided, however, that future published guidance may require an employer to file corrected information returns and to furnish corrected statements to employees for any previously unreported amounts that were includible in gross income under Code Section 409A during 2005.

Specifically, for calendar year 2005, an employer is not required to report deferrals under a non-qualified deferred compensation plan in Box 12 of IRS Form W-2 using Code Y. Similarly, payments to service providers that are otherwise reported on IRS Form 1099 need not include non-qualified deferred compensation earned during calendar year 2005.

The suspension of the reporting and withholding requirements for calendar year 2005 does not affect an employer's reporting and withholding obligations for FICA and Medicare taxes on non-qualified deferred compensation earned during 2005 or an employer's reporting and withholding obligations with respect to non-qualified deferred compensation actually (or constructively) paid during 2005. Those reporting and withholding obligations continue as in prior years.

### **Extension of Deadline to Adopt Automatic Cash-Out/Rollover Amendment.**

In Notice 2005-95, the IRS extended the deadline for employers to amend their tax-qualified retirement plans to reflect plan administrative practices with respect to mandatory cash-outs and automatic rollovers. Plan amendments are required to reflect changes made by the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"). Generally, EGTRRA requires that, if a plan provides for mandatory cash-outs of \$1,001 to \$5,000, then the cash-out amount must be rolled over (by the plan administrator) into an individual retirement account ("IRA") established for the participant (by the plan administrator), unless the participant directs otherwise.

Prior to the issuance of the Notice, the deadline for making any necessary amendments had been the end of the first plan year that ended on or after March 28, 2005 (i.e., December 31, 2005 for calendar year plans). The deadline for adopting the necessary amendment has now been extended to the later of December 31, 2005, the end of the plan year that contains March 28, 2005, or the deadline (including extensions) for filing the employer's income tax return for its taxable year that includes March 28, 2005.

If you have any questions, please contact Steve Daley (315-218-8237; [sdaley@bsk.com](mailto:sdaley@bsk.com)) or any of the other members of our Employee Benefits Law Practice Group listed below:

*In Central New York, call 315-218-8000 or e-mail:*

Lisa A. Christensen	<a href="mailto:lchristensen@bsk.com">lchristensen@bsk.com</a>
John C. Godsoe	<a href="mailto:jgodsoe@bsk.com">jgodsoe@bsk.com</a>
Brian K. Haynes	<a href="mailto:bhaynes@bsk.com">bhaynes@bsk.com</a>
Richard D. Hole	<a href="mailto:rhole@bsk.com">rhole@bsk.com</a>
Ted Lewkowicz	<a href="mailto:tlewkowicz@bsk.com">tlewkowicz@bsk.com</a>
Aaron M. Pierce	<a href="mailto:apierce@bsk.com">apierce@bsk.com</a>

*In the Capital District, call 518-533-3000 or e-mail:*

Joanmarie M. Dowling	<a href="mailto:jdowling@bsk.com">jdowling@bsk.com</a>
Amelia M. Klein	<a href="mailto:aklein@bsk.com">aklein@bsk.com</a>

*In Western New York, call 716-566-2800 or e-mail:*

Darcie A. Falsioni	<a href="mailto:dfalsioni@bsk.com">dfalsioni@bsk.com</a>
--------------------	--

In New York City and on Long Island, please contact any of the following members of our Labor and Employment Law Department:

*On Long Island, call 516-267-6300 or e-mail:*

Terry O'Neil	<a href="mailto:toneil@bsk.com">toneil@bsk.com</a>
--------------	--

*In New York City, call 646-253-2300 or e-mail:*

Louis P. DiLorenzo	<a href="mailto:ldilorenzo@bsk.com">ldilorenzo@bsk.com</a>
--------------------	--