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ALSO IN THIS ISSUE –

Collin W. Fritz and Associates, Inc.,
"The Pension Specialists"

Understanding the RMD Rules As They Apply to Spouses

A Spouse Beneficiary's Right to Roll Over a Distribution from Deceased Spouse's IRA to His or Her Own IRA

Even though a spouse beneficiary no longer has the right to treat a deceased spouse's IRA as his or her own IRA if he or she is not the sole beneficiary, such spouse beneficiary is still entitled to roll over an amount paid from a deceased spouse's IRA to his or her own IRA. That is, any amount paid to a spouse in excess of his or her applicable share of the decedent's RMD is eligible to be rolled over to his or her own IRA.

No Inherited IRA if the Surviving Spouse Elects as Own

There is no inherited IRA when a surviving spouse elects to treat the IRA of the deceased spouse as his or her own. In general, the inherited beneficiary rules do NOT apply when a surviving spouse, who was the sole beneficiary, elects to treat his or her deceased spouse's IRA as his or her own.

For informational purposes, it may be nice for an IRA custodian to know that the funds in a person's IRA arose because they acquired their deceased spouse's IRA. However, from an income tax standpoint, when the surviving spouse takes a distribution from his or her IRA, it is as if he or she had been the original contributor of the funds.

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IRS Guidance on KETRA Tax Law Changes

Most of the law chances made by the Katrina Emergency Tax Relief Act of 2005 (KETRA) are readily understandable, but some guidance was needed with respect to the interplay of the ratable inclusion of income over 3 years and the 3-year rollover (or re-contribution) period. The IRS recently issued Notice 2005-92 as set forth in the Internal Revenue Bulletin of December 19, 2005. This Notice provides the additional guidance. The Notice discusses KETRA in terms of what the plan sponsor or plan administrator must do and what the individual must do. There is no express discussion of the duties of an IRA custodian, as there is for plan administrators. In general, it is reasonable to assume that an IRA custodian will have the same or very similar duties as a plan administrator.

1. The IRS has adopted the approach that a qualified individual will need to designate a distribution as a Katrina distribution. IRA and qualified plan distribution forms will need to be modified to provide for this designation. CWF now has these forms available. An individual will need to certify that he or she had his or her principal place of abode on August 28, 2005, in one of the following states: Louisiana, Mississippi, Alabama or Florida, and the individual will need to certify that he or she suffered an economic loss on account of Hurricane Katrina. Although to qualify

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No Inherited IRA if the Surviving Spouse Takes a Distribution from the Deceased Spouse's IRA and Rolls It Over to His or Her IRA

When a surviving spouse makes a rollover contribution into his or her own IRA of funds distributed from a deceased spouse's IRA, his or her IRA is not an inherited IRA, and the RMD rules for living accountholders will apply rather than the RMD rules which apply to an inheriting beneficiary.

IRA Owner Dies When Younger than Age 70½, and Spouse Beneficiary Is Younger than Age 70½

There is no RMD due, since the IRA owner died before his or her required beginning date. As discussed below, in some situations a surviving spouse may wish to wait before treating it as his or her own IRA.

IRA Owner Dies During the Year of Attaining Age 70½, but Spouse Beneficiary Is Younger than Age 70½

There is no RMD for the year the IRA owner attains or would have attained age 70½, if he or she dies before his or her required beginning date.

IRA Owner Younger than Age 70½, but Spouse Beneficiary Is Older than Age 70½

The spouse beneficiary is not required to take a distribution for the year of death because of the governing rule—calculate the RMD for the year of death as if the account owner had not died. Since the IRA owner was not subject to the RMD rules, there is no distribution done. The spouse will need to take an RMD the following year.

IRA Owner Over Age 70½, but Spouse Beneficiary Is Younger than Age 70½

John is age 75, and he dies in 2005. His wife, Ann, was his sole beneficiary. Ann's date of birth was 5-5-43. She will not attain age 70½ until 11-5-2013. If Ann elects to treat John's IRA as her own in 2005, the RMD amount as calculated for John is required to be distributed to Ann for 2005. She will not be required to take another distribution until she personally becomes subject to the RMD rules as an IRA account owner. She attains age 70½ in 2013. She will be required to take an RMD for 2013, but not before then, except for the amount calculated for John for 2005.

IRA Owner and Spouse Beneficiary Both Over Age 70½, but the Spouse Beneficiary Is Younger than the IRA Owner

Illustration #1. John Jones was the IRA owner. His date of birth was 2-10-31. He died on January 30, 2005. He would have attained age 74 in 2005. His IRA account balance as of 12-31-04 was $38,000. In January of 2005, the IRA custodian had calculated his RMD for 2005 to be $1,603.38 ($38,000/23.7). No portion of his 2005 RMD had been distributed to him prior to his death. His wife, Ann, was his sole beneficiary. Ann's date of birth was 5-5-33. She will attain age 72 in 2005. Ann (72) is younger than John (74). Consequently, she will most likely want to treat his IRA as her own in 2005. She must be paid the amount of $1,603.38 — the amount which would have been distributed to John, if he had lived. For 2006, the RMD for Ann will be based on Ann's age of 73 and the Uniform Life Table.

IRA Owner and Spouse Beneficiary Both Over Age 70½, but the Spouse Beneficiary Is Older than the IRA Owner

Illustration #2. Same situation as Illustration #1 except Ann's date of birth was 5-5-28. She will attain age 77 in 2005. Ann (77) is older than John (74). The 2005 RMD amount using John's age is $1,603.38. Even though Ann elects to treat John's IRA as her own in 2005, she is only required to withdraw $1,603.38 (i.e. John's RMD amount). Ann will calculate her RMD for 2006 by using her age in 2006 and by using the Uniform Lifetime Table.

Summary. Most surviving spouses will either elect to treat their deceased spouse's IRA as their own IRA or they will roll over the RMD distribution from the decedent's IRA into their own IRA. The general rule is that any RMD amount which was calculated for the decedent, but which was not paid to the decedent prior to his/her death, will need to be distributed to the surviving spouse. By electing to treat the IRA as his or her own, the surviving spouse will be able to use the uniform life-time table rather than the single table which must be used with respect to an inherited IRA. There are some situations where a surviving spouse will not want to treat their deceased spouse's IRA as their own. This subject was discussed in the October 2003 newsletter.

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as a qualified individual a person must have suffered an economic loss on account of Hurricane Katrina, a distribution will qualify as a Katrina distribution without regard to whether or not an individual is one who "needs" the distribution, and without regard to whether the amount being distributed exceeds the amount of economic loss suffered by the individual.

The IRA custodian (plan administrator) is entitled to rely on reasonable representations from the IRA accountholder or the inheriting IRA beneficiary with respect to his or her place of bode on August 28, 2005, and whether he or she suffered economic loss by reason of Hurricane Katrina, unless there is actual knowledge to the contrary.

Example #1. A section 401(k) plan distributed $35,000 to a qualified individual on December 1, 2005. The qualified individual also received a distribution from his or her IRA on December 1, 2005. The individual is permitted to treat both distributions as Katrina distributions on his or her 2005 federal income tax return.

Example #2. A qualified individual (age 51) receives a distribution of $50,000 in 2005 and a distribution of $75,000 in 2006. Only $100,000 of the $125,000 received by the individual may be treated as a Katrina distribution. Thus, if the individual treated the 2005 distribution of $50,000 as a Katrina distribution, there is only $50,000 remaining which may be treated as a Katrina distribution for 2006. The remaining $25,000 will not be a Katrina distribution; it will be subject to the 10% additional tax (it is assumed there is no other exception applying). It will be ineligible for the 3-year spread treatment and it is ineligible to be re-contributed or rolled over within the 3-year period.

2. Under KETRA, a qualified recipient is allowed to spread the KETRA distribution over three taxable years. Unless elected otherwise, 1/3 of the distribution is included in income for the year of receipt, and then 1/3 of the distribution is included in income for each of the next two years.

A KETRA distribution is any distribution from an eligible retirement plan made on or after August 25, 2005, and before January 1, 2007. An individual is limited to having no more than $100,000 of KETRA distributions. This means a person who received a distribution in 2005 will include 33.3% in income for 2005, 2006 and 2007, and a person who received a distribution in 2006 will include 33.3% in income for 2006, 2007 and 2008.

An individual is permitted to not use the 3-year rule. He or she may include the entire distribution in income for the year of receipt. The IRS has clarified this rule by stating that "all Katrina distributions received in a taxable year must be treated consistently" (either all distributions are included in income over a 3-year period, or all distributions are included in income in the current year). The individual will not be able to change his or her election after the timely filing of the individual's tax return (including extensions) for the year of the distribution.

Example. Taxpayer A receives a $30,000 distribution from his or her IRA on October 1, 2005. Taxpayer A is a qualified individual and elects to treat the distribution as a Katrina distribution. Taxpayer A uses the 3-year ratable income inclusion for the $30,000 distribution. Taxpayer A should include $10,000 in income with respect to the Katrina distribution on each of his or her 2005, 2006 and 2007 tax returns.

Special Exception. The 3-year ratable taxation method will be modified if the qualified individual dies before the full taxable amount of the Katrina distribution has been included in his or her income, then the remainder must be included in the income of the qualified individual for the tax year which includes his or her death.

3. What has the IRS said about the $100,000 limit? KETRA limits the amount of distributions from all sources (IRAs and pension plans) that can be treated as Katrina distributions to no more than $100,000. It is clearly stated that an employer will be required to limit those distributions which a participant designates as Katrina distributions to $100,000. If an employer sponsors multiple plans, the employer is required to aggregate the distributions from all such plans. The employer is not, however, required to consider or accumulate information about distributions from IRAs or from other pension plans sponsored by unrelated employers. We at CWF believe an IRA custodian/trustee is required to enforce the $100,000 limit with respect to distributions from IRAs and pension plans of which it is the custodian/trustee.

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4. Has the IRS Created a New Form 8915, Qualified Hurricane Katrina Retirement Plan Distributions and Repayments? Yes. This form will have two purposes. It will be used to determine the amount of the Katrina distribution includible in income for the taxable year and to report any re-contribution made during the taxable year. The final version of this form for 2005 was not available when this article was written.

5. The IRS clarifies that a Katrina distribution is not subject to the 10% additional tax which applies to most pre-age 59½ distributions from IRAs and eligible employer plans. However, the IRS clarifies that the 25% tax will also not be owed if the Katrina distribution is from a SIMPLE IRA plan.

6. Do all distributions to a qualified person qualify as a Katrina distribution? The answer is, "No." However, most distributions do qualify. The IRS clarifies that periodic payments and required minimum distributions made between August 25, 2005, and before January 1, 2007, are Katrina distributions which qualify for the special 3-year inclusion treatment. Similarly, distributions received by a qualified individual as a beneficiary qualify as a Katrina distribution and the 3-year inclusion rule. In addition, a reduction or offset of a participant's account balance in order to repay a plan loan is permitted to be treated as a Katrina distribution. There are some distributions which do not qualify as Katrina distributions. Any type of correcting distribution from an employer plan does not qualify. A defaulted loan that is treated as distributed is not treated as a Katrina distribution. There is no discussion of whether the withdrawal of an excess IRA contribution qualifies. The conservative approach is that such a distribution does not qualify as a Katrina distribution, since it is a type of correcting distribution.

7. A qualified individual is permitted to re-contribute any portion of a Katrina distribution that is eligible for tax-free rollover treatment to an eligible retirement plan at any time in the 3-year period beginning the day after the date of the distribution, and it will be treated as if it were paid in a direct rollover to an eligible retirement plan. A re-contribution is not treated as a rollover contribution for purpose of the one-rollover-per-year restriction. It appears that every Katrina distribution may be re-contributed as long as the above rules are met.

8. What tax reporting is required by an IRA custodian or a QP plan trustee for a Katrina distribution? The IRA custodian or the QP plan trustee will be required to prepare a Form 1099-R to report every Katrina distribution. This is required even if the recipient re-contributes the funds within the same year the distribution took place.

The IRS, at this time, has chosen to not create a special reporting code for Katrina distributions.

The IRS has said that the IRA custodian or QP trustee may use Code 2 (early distribution, exception applies) if it knows the distribution is a Katrina distribution, or it may use Code 1 (early distribution, no known exception). By requiring the individual to complete the Form 8915, the IRS does not need to depend on how Box 7 (reason code) of the Form 1099-R has been completed.

9. What tax treatment applies if the individual has used the 1-year income inclusion method and then re-contributes some or all of the Katrina distribution? The re-contribution(s) lowers the amount to be included in income for the year of the distribution. The re-contribution may occur during the same year as the distribution or during the 3-year period commencing the day after the distribution. As long as the re-contribution takes place before the IRA account-holder files that year's tax return, the individual will be able to report the transaction on that year's tax return. If the re-contribution occurs after that year's tax return has been filed, then the individual will need to file an amended return for such year.

Three examples as written by the IRS are set forth:

Example #1. Taxpayer B receives a $45,000 distribution from a section 403(b) plan on November 1, 2005. Taxpayer B is a qualified individual and treats the distribution as a Katrina distribution. Taxpayer B receives no other Katrina distribution from any eligible retirement plan or IRA in 2005. After receiving reimbursement from his or her insurance company for a casualty loss, Taxpayer B re-contributes $45,000 to an IRA on March 31, 2006. Taxpayer B reports the re-contribution on Form 8915 and files the 2005 tax return on April 10, 2006. For Taxpayer B, no portion of the Katrina distribution is includible as income for the 2005 tax year.

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Example #2. The facts are the same as Example #1 except that Taxpayer B timely requests an extension of time to file the 2005 tax return and makes a re-contribution on August 2, 2006, before he or she files the 2005 tax return. Taxpayer B files the 2005 tax return on August 10, 2006. As in Example #1, no portion of the Katrina distribution is includible in income for the 2005 year because Taxpayer B made the re-contribution before the timely filing of the 2005 return.

Example #3. Taxpayer C receives a $15,000 distribution from a section 457(b) plan on January 10, 2006. Taxpayer C is a qualified individual and treats the distribution as a Katrina distribution. Taxpayer C elects out of the 3-year ratable income inclusion on Form 8915 and includes the entire $15,000 in gross income for the 2006 taxable year. On December 31, 2008, Taxpayer C re-contributes $15,000 to the section 457(b) plan. Taxpayer C will need to file an amended return for the 2006 tax year to report the amount of the re-contribution and reduce Taxpayer's C gross income by $15,000 with respect to the Katrina distribution on the 2006 original tax return.

10. What tax treatment applies if the individual has used the 3-year ratable income inclusion method and then re-contributes some or all of the Katrina distribution?

Again, the re-contribution(s) lowers the amount to be included in income. However, when the 3-year ratable method is used, the general rule will be — the amount of the re-contribution will reduce the ratable portion of the Katrina distribution that is includible in gross income for the tax year of the filed return as long as the re-contribution occurs before the timely filing of the individual's tax return (i.e. by the due date, including extensions). Set forth below are two examples as written by the IRS.

Example #1. Taxpayer D receives a $75,000 distribution from a section 401(k) plan on December 1, 2005. Taxpayer D is a qualified individual and treats the $75,000 distribution as a Katrina distribution. Taxpayer D uses the 3-year ratable income inclusion method for the distribution. Taxpayer D makes one re-contribution of $25,000 to the section 401(k) plan on April 10, 2007. Taxpayer D files the 2006 tax return on April 15, 2007. Without the re-contribution, Taxpayer D should include $25,000 in income with respect to the Katrina distribution on each of D's 2005, 2006 and 2007 tax returns. However, as a result of the re-contribution to the section 401(k) plan, Taxpayer D should include $25,000 in income with respect to the Katrina distribution on the 2005 tax return, $0 in income with respect to Katrina distribution on his 2006 tax return, and $25,000 in income with respect to the Katrina distribution on his 2007 tax return.

Example #2. The facts are the same as Example #1 except that Taxpayer D re-contributes $25,000 to the section 401(k) plan on August 10, 2007. Taxpayer D files the 2006 tax return on August 15, 2007, and does not request an extension of time to file the return. As a result of the re-contribution to the section 401(k) plan, Taxpayer D should include $25,000 in income with respect to the Katrina distribution on the 2005 tax return, $25,000 in income with respect to the Katrina distribution on the 2006 tax return, and $0 in income with respect to the Katrina distribution on the 2007 tax return.

If the re-contribution amount exceeds the amount which is otherwise includible in income for the tax year of the filed return, the excess amount of the re-contribution is permitted to be carried forward to reduce the amount of the Katrina distribution includible in income for the following year or it may be carried back to the prior year to reduce the amount of the Katrina distribution to be included in income for the prior year. The individual will need to file an amended return for the prior taxable year or years to report the amount of the re-contribution on Form 8915 and reduce his or her gross income by the excess amount of the re-contribution. Set forth below is an example illustrating the two options which are available.

Example. Taxpayer E receives a $90,000 distribution from his or her IRA on November 15, 2005. Taxpayer E is a qualified individual and treats the distribution as a Katrina distribution. Taxpayer E ratably includes the $90,000 distribution over a 3-year period. Without any re-contribution, Taxpayer E will include $30,000 in income with respect to the Katrina distribution on each of the 2005, 2006 and 2007 tax returns. Taxpayer E includes $30,000 in income with respect to the Katrina distribution on the 2005 tax return.

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Taxpayer E then re-contributes $45,000 to an IRA on November 10, 2006 (and made no other re-contribution in the 3-year period). Taxpayer E is permitted to do either of the following:

Option #1. Taxpayer E includes $0 in income with respect to the Katrina distribution on the 2006 tax return. Taxpayer E carries forward the excess re-contribution of $15,000 to 2007 and includes $15,000 in income with respect to the Katrina distribution on E's 2007 tax return.

Option #2. Taxpayer E includes $0 in income with respect to the Katrina distribution on the 2006 tax return and $30,000 in income on the 2007 tax return. Taxpayer E then files an amended return for 2005 to reduce the amount included in income (i.e. reflect the carry-back) as a result of the Katrina distribution to $15,000.

11. Additional Guidance. The IRS states the rule that the receipt of a Katrina distribution in addition to those which are made pursuant to a schedule for substantially equal periodic payments does not result in an impermissible change so that the various penalty taxes will apply. Any Katrina distribution is apparently a permissible distribution and is a new major exception to the rules regarding what modifications in a substantially equal periodic payment schedule result in an impermissible change.

When Taking More Is Less

And we mean more income, with no increase in taxes!

Once an IRA accountholder attains age $70^1/_2$, an annual required minimum distribution commences. Sometimes the accountholder is so concerned with taking out just the minimum, an available tax advantage is allowed to slip away.

Example 1: Phyllis, age 75 and single, has a 2005 RMD in the amount of $1,800, and total income in the amount of $6,800. This means she is not required to file a federal tax return. The minimum income requirement for filing a 2005 federal return is $9,450 for someone over the age of 64, whose filing status is single.

Consequently, Phyllis could take an additional IRA distribution in the amount of $2,649 ($9,449 - $6,800) and still not be required to file a federal tax return or pay any taxes. She has taken an extra $2,649 TAX FREE!

Example 2: George and Harriet are married and both are over age $70^1/_2$. Their RMDs for 2005 are $2,000 for George and $2,500 for Harriet. They have total income in 2005 of $15,000. They file their federal tax return jointly, but are not required to file, because their joint income is less than $18,400.

In this example, George and Harriet can take an additional IRA distribution in the amount of $3,399 ($18,399 - $15,000) and still not be required to file a federal tax return. That means they could take an additional $3,399 TAX FREE.

In both cases, it would have been possible for the IRA accountholders to take additional IRA distributions without requiring the filing of a federal tax return and without increasing their tax liability. Tax-free income is something everyone can relate to.

Since there may also be state income tax consequences and filing requirements, the IRA accountholder should always review his/her particular circumstances with his/her own tax advisor.

Year-End IRA Questions

This time of year we can all expect a number of IRA questions. Here are some of the more common.

Q1 – What is the last day an IRA accountholder can make a 2005 contribution?

A1 – The last day to make a 2005 traditional or Roth IRA contribution is the due date of his/her federal tax return, not including extensions. For most of us that is April 15. Since April 15 falls on a weekend in 2006, the due date is extended to Monday, April 17, 2006. If your federal filing area is affected by a state holiday, like Patriot's Day in parts of New England, the final due date is extended to Tuesday, April 18, 2006.

Q2 – The IRA accountholder does not attain age $70^1/_2$ until June 2006. Can he/she make a traditional IRA contribution for 2006, as long as it is made before attaining age $70^1/_2$?

A2 – No, for contribution purposes, the entire year an accountholder attains age $70^1/_2$, whether in January

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or December, is disqualified for traditional IRA contributions. Remember, however, Roth IRA contributions do not have an age restriction.

Q3 – Our IRA accountholder attained age 70½ in January 2006. Can he/she make a traditional IRA contribution for 2005?

A3 – Yes. Even though the IRA accountholder has already attained age 70½, since it was not attained until 2006, a 2005 traditional IRA contribution can be made in 2006, for 2005. Remember, the deadline for making this contribution is April 17, 2006, and the contribution must be designated for 2005. And again, Roth IRA contributions do not have any age restriction.

Special Relief Extended for State Mandates

A health plan which has first-dollar coverage for some medical events or which has a deductible below the $1,000 (as indexed) or $2,000 (as indexed) does not qualify as a high deductible health plan. An individual covered by such a health plan is ineligible to make an annual HSA contribution.

The IRS made clear in Notice 2004-2 that a health plan subject to state law requirements that mandate first dollar coverage or a lower deductible as of January 1, 2004, does not qualify as an HDHP. The IRS decided to create a special transitional rule. For the 2-year period commencing on January 1, 2004, to December 31, 2005, a person was still be eligible to make an HSA contribution regardless of a disqualifying provision due to a state mandate. However, the IRS stated that this special rule ceased to apply on or after January 1, 2006, because the states had been given time to changes their state laws.

In Notice 2005-83, the IRS chose to issue additional guidance and relief with respect to the state mandate issue. Why? A general rule of health insurance law is that a health plan may not reduce existing benefits before the health plan's renewal date. Therefore, a non-calendar-year health plan could fail to qualify as an HDHP even though a state did amend its laws prior to January 1, 2006. For example, a health plan (with a renewal date of July 1, 2005) is amended on September 15, 2005, after the state changed its law on August 1, 2005, by eliminating a first-dollar coverage requirement for certain medical events air. This health plan appears to qualify as an HDHP. However, many states have laws that do not permit the change to go into effect until the following renewal date. This means the health plan does not qualify as an HDHP until July 1, 2006.

The IRS concluded that additional relief was appropriate for this situation. That is, a plan which otherwise does not qualify as an HDHP because of a state mandate will be treated as an HDHP for a portion of 2006. If a noncalendar year health plan complied with a state mandate (in effect on January 1-1-04) so that it provided certain benefits without regard to a deductible or with a deductible below the minimum HSA annual deductible limit, the health plan will still qualify as an HDHP. This special relief ends on the earlier of the health plan's next renewal date or December 31, 2006. In the above example, the relief would end on July 1, 2006.

How Do the New Grace Period Rules for Cafeteria Plans Impact HSA Eligibility?

In Notice 2005-42 (September of 2005) the IRS authorized an employer, who sponsors a cafeteria plan, to adopt a grace period for its cafeteria plan. Prior to this Notice, the use-it-or-lose it rule applied, with no exception. The purpose of the grace period was to provide limited relief for participants from the use-it-or-lose-it rule. The effect of the grace period is that an individual who incurs expenses for a qualified benefit during the grace period will be allowed to have the cafeteria plan pay for those expenses from the funds in the appropriate cafeteria plan account. That is, the funds which otherwise would have been lost, since they had not been used by plan-year end, can still be used and not lost, if done so during the grace period.

Notice 2005-42 permitted a cafeteria plan to be amended by an employer to provide a grace period immediately following the end of each plan year to provide limited relief from the "use-it-or-lose-it rule." Many employers have done so.

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In Notice 2005-42 the IRS stated the following rules. The maximum term for a grace period was defined to be 2½ months. It is permissible to define the grace period as a period shorter than 2½ months. 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, and it remains in effect for the entire grace period even though the participant may terminate employment on or before the last day of the grace period. A grace period does not need to be provided for every covered benefit. That is, an employer may limit the availability of the grace period to only certain cafeteria plan benefits and not others.

In Notice 2005-86, the IRS discusses how the new grace period rules will impact a person's eligibility for an HSA.

A cafeteria plan may provide, as a benefit, a general-purpose health flexible-spending arrangement. Under such a plan, the health flexible-spending arrangement reimburses all qualified section 213(d) medical expenses. The general rule, as set forth in Notice 2004-2, is that participating in a general health flexible-spending arrangement makes a person ineligible to contribute to an HSA, because the general-purpose health flexible-spending arrangement is considered to be a health plan without a high deductible. However, there are a number of special types of health flexible-spending accounts which do not have this result. A person covered by under a limited-purpose health flexible spending arrangement (i.e. it pays for preventive care expenses or permitted coverage such as dental and vision care) remains eligible for the HSA. A person covered under a post-deductible health flexible-spending arrangement (i.e. it pays for expenses only after the HSA deductible has met) remains eligible for the HSA.

Therefore, the general rule for HSA eligibility purposes is — an individual participating in a general-purpose health flexible-spending arrangement who is covered by a grace period, is ineligible to contribute to an HSA until he or she is no longer covered by the grace period. The individual is eligible to contribute to an HSA on the first day of the first month following the end of the grace period, even if he or she did not have any unused benefits at the end of the prior cafeteria plan year. But see the transition rule discussed below.

Some employers will choose to amend their health flexible-spending arrangement during the grace period from providing general coverage to one which only provides a limited purpose or a post-deductible health flexible-spending arrangement. If the amendments do not permit an individual to elect between an HSA-compatible flexible-spending arrangement or a flexible-spending arrangement which is not HSA compatible, then coverage of these individuals by the HSA-compatible flexible-spending arrangement during the grace period are eligible to make an HSA contribution.

In addition, the IRS chose, in Notice 2005-86, to grant some transition relief to certain individuals participating in a general-purpose health flexible-spending arrangement even though general-purpose coverage is provided during the grace period. Such individuals will be eligible to contribute to an HSA. Transition relief is granted in two situations. This transition rule applies only with respect to cafeteria plan years ending before June 5, 2006, and only applies if the following requirements are met.

Under both situations, to qualify for the transitional relief, the individual must be eligible for an HSA during the grace period, assuming he or she was not covered by the general-purpose health flexible-spending arrangement. And also have coverage under a HDHP and not be covered under a low deductible plan.

In the first situation, there must be no unused contributions or benefits at the end of the immediately-preceding cafeteria plan year in the general-purpose health flexible-spending arrangement of the individual or the general-purpose health spending arrangement of his or her spouse.

The second situation applies to an individual who is not covered during the grace period under a general-purpose health flexible-spending arrangement maintained by the employer of his or her spouse. He or she will be eligible to contribute to an HSA, as long as his or her employer amends its cafeteria plan to provide that the grace period does not provide coverage to an individual who elects HDHP coverage.

Summary. The general rule is that a person participating in a general-purpose health flexible-spending arrangement will be ineligible to contribute to an HSA during any grace period. However, it is permissible for an employer to amend its plan during the grace period to adopt a limited-purpose or a post-deductible health flexible-spending arrangement.