IRS Provides Guidance on Rollovers to Health Savings Accounts

Late last year Congress enacted legislation designed to increase the attractiveness of health savings accounts (HSAs). The new law makes it easier for individuals participating in health FSAs and HRAs to become eligible for HSA contributions by allowing rollovers of account balances to HSAs. The IRS has now issued guidance that explains in more detail how these rollovers can be made, including a limited transition rule for rollovers of amounts in HRAs and certain health FSAs at the end of 2006.

Background

A health savings account (HSA) is a tax-exempt savings account funded by individual and/or employer cash contributions to be used to pay for qualified medical expenses. Eligibility for HSA contributions is determined on a monthly basis – to be eligible for HSA contributions, the individual must be covered under a high-deductible health plan (HDHP) on the first day of that month and have no other non-HDHP health coverage. Coverage under a health flexible spending account (FSA) or a health reimbursement account (HRA) generally precludes eligibility for HSA contributions.

In 2005, the IRS authorized an FSA grace period of up to 2½ months following the end of the plan year in which health FSA participants could incur eligible expenses, which many employers adopted. The IRS later confirmed that an individual who participated in a health FSA with a grace period would not be eligible for HSA contributions until the first day of the month following the end of the grace period – even if the individual had a zero FSA balance at the end of the year. Employers that had adopted the grace period and were also offering an HDHP/HSA option could either convert the health FSA to an HSA-compatible FSA (e.g., one that only reimburses dental or vision expenses) during the grace period for all participants in the health FSA, or limit affected individuals to a prorated amount of HSA contributions for 2007. (See our December 7, 2005 For Your Information.)

The Tax Relief and Health Care Act of 2006 included a number of provisions intended to enhance the attractiveness of HSAs. For example, the law permits those with a zero FSA or HRA balance at the end of the year to be HSA-eligible as of the beginning of the next year and permits those not eligible to contribute for the entire year to still make the annual maximum HSA contribution for the year. The new law also authorizes employers to permit rollovers of FSA or HRA balances to HSAs, which, if certain conditions are satisfied, will...
enable an FSA or HRA participant to be HSA-eligible on the first day of HDHP coverage. (See our December 20, 2006 *For Your Information*.)

The IRS recently issued *Notice 2007-22*, which provides much needed guidance on how these provisions apply.

**Notice 2007-22**

The guidance in Notice 2007-22 is directed at employers with HSA eligibility problems caused by general purpose health FSAs with grace periods and general purpose HRAs. It sets out in detail the rules for making direct rollovers of health FSA or HRA balances to an HSA to permit an employee to be eligible for HSA contributions from the first day of HDHP coverage. It also provides guidance on when an employee participating in a health FSA with a grace period or an HRA will be considered to have a “zero balance” at the end of a plan year.

**Rollovers from FSAs and HRAs to HSAs**

The 2006 law permits, but does not require, an employer to provide employees with the opportunity to make a “qualified HSA distribution” – i.e., a one-time rollover of amounts from an employee’s health FSA or HRA to the employee’s HSA. The distribution must be made before January 1, 2012 and cannot exceed the lesser of the balance in the health FSA or HRA on September 21, 2006, or on the date of the distribution. The amount of the rollover is not counted against the annual HSA contribution limit and generally is not includible in the employee’s income. However, except in limited circumstances, if an employee is not HSA-eligible immediately following the qualified HSA distribution and during the 12-month period immediately following the distribution, the distribution is includible in income and is subject to an additional 10 percent tax.

The notice provides that in order for an employee to make a qualified HSA distribution that will permit health FSA coverage during a grace period or HRA coverage to be disregarded for purposes of HSA eligibility, each of the following conditions must be satisfied –

- The health FSA or HRA plan must be amended to permit qualified HSA distributions by the last day of the plan year. Examples in the notice indicate that the amendment should also specify that the employee’s health FSA or HRA account balance will be “frozen” as of the end of the year – even with respect to claims submitted prior to the end of the plan year that have not yet been reimbursed.
- The employee must elect to make a qualified HSA distribution by the last day of the plan year. Thus, it might be advisable to include the election form in annual enrollment materials.
- The health FSA or HRA cannot make any reimbursements to the employee after the last day of the plan year. This includes reimbursements for expenses incurred and/or submitted before the end of the plan year.
- The employee must not have made a previous rollover to an HSA from that particular health FSA or HRA.
The employer must transfer funds directly to the HSA within 2½ months after the end of the plan year, but after the employee becomes HSA-eligible. Thus, funds representing account balances of health FSAs and HRAs with calendar year plan years must be transferred by March 15 of the following calendar year.

There must be a zero balance in the employee’s health FSA or HRA after the transfer, or the health FSA or HRA must have been converted to an HSA-compatible health FSA or HRA on or before the transfer.

The employee may not participate in a non-HSA-compatible plan after the transfer.

**Basis for Determining Account Balances.** The notice clarifies that account balances are to be determined on a cash basis, meaning that the balance as of any date is determined without taking into account any claims for expenses that have not been reimbursed as of that date, regardless of when incurred or submitted. The notice further provides that the balance of a health FSA as of any date is determined by applying the uniform coverage rule (i.e., maximum reimbursement available for the plan year reduced for prior reimbursements paid as of that date).

**Eligibility for Rollovers.** The notice clarifies that only an employee who has a balance at the end of a plan year in a health FSA with a grace period or HRA is eligible to make a tax-free rollover. Tax-free rollovers are not available to those participating in health FSAs without grace periods because the account balance is forfeited (the FSA has a zero balance) at the end of the plan year.

The notice also provides that because the amount of a qualified HSA distribution cannot exceed the lesser of the employee’s health FSA or HRA balance on September 21, 2006 or on the distribution date, an individual who did not participate in a health FSA or HRA on September 21, 2006 (and thus had no balance on that date) will not be eligible to make a qualified HSA distribution. Finally, the notice clarifies that an individual who participated in a health FSA or HRA of one employer on September 21, 2006 but who later participates in a health FSA or HRA of a second employer may not make a qualified HSA distribution with respect to the second employer’s health FSA or HRA.

**BUCK COMMENT.** Employers who contemplate allowing rollovers to HSAs should act now to obtain a “snapshot” of each participant’s health FSA or HRA account as of September 21, 2006. This will enable employers to determine whether an employee is eligible to make a rollover and the maximum amount of the rollover.

**Effective Date of HDHP Coverage.** The notice emphasizes that in order to avoid taxation of the distribution, the employee’s HDHP coverage must be in effect as of the first day of the month in which the qualified HSA distribution is made.

**BUCK COMMENT.** Thus, the timing of the distribution is critical. If, for example, an employee’s HDHP coverage does not become effective until January 15, the qualified HSA distribution should be made no earlier than February 1. If a qualified HSA distribution is made before February 1, the amount of the distribution is included in the employee’s income and subject to an additional 10 percent tax.
Mid-year Rollovers. The notice clarifies that although transfers of FSA or HRA balances to HSAs can be made at times other than at the end of the plan year, an employee who makes a mid-year rollover from a health FSA or HRA generally will still be considered as having that coverage through the end of the plan year – even if the account balance is zero. This means that the employee will be treated as having non-HSA-compatible coverage until the end of the plan year and that the rollover will be included in the employee’s income and subject to the 10% additional tax.

Additional Tax Consequences. Distributions from HSAs that are not used for qualified medical expenses are includible in income and subject to an additional 10% tax. As noted above, if an employee is not HSA-eligible immediately after and during the 12-month period following a rollover, the amount of the rollover is includible in income and subject to an additional 10% tax. The notice clarifies that the taxation of distributions for nonqualified expenses will apply to amounts that were already subject to tax due to loss of HSA eligibility, thus potentially resulting in double taxation.

Reporting Requirements. The notice provides that rollover amounts are not reported on the employee’s W-2 and the employer is not responsible for reporting whether an employee remains an eligible individual. However, employers must report qualified HSA distributions as rollover contributions to the HSA trustee (who must report them on Form 5498-SA).

Transition Rule for 2006 Balances

The notice provides a limited transition rule that employers may use for employees who had account balances remaining in their general purpose health FSAs or general purpose HRAs after December 31, 2006. Under this rule, employees will be treated as HSA-eligible as of January 1, 2007 if the conditions for rollovers discussed above are met, but with the following modifications –

- The amendment permitting qualified HSA distributions from the health FSA or HRA must be made effective on or before March 15, 2007.
- The employee’s election to have the employer make a qualified HSA distribution must be made on or before March 15, 2007.
- The employer must make the qualified HSA distribution directly to the HSA trustee by March 15, 2007, but after the date the employee becomes HSA-eligible (i.e., the individual must have coverage under an HDHP as of the first day of the month in which the distribution is made).
- The requirement that the individual not have received any reimbursements from the health FSA or the HRA after the last day of the plan year does not apply.
Considerations for FSA and HRA Sponsors

Before taking any action, employers need to determine whether it makes sense for them to permit rollovers.

Employers with Health FSAs with Grace Periods. Prior to the 2006 law, an employee who had an account balance during a health FSA grace period ending on March 15 would not become eligible for HSA contributions until April 1, which meant that the contributions to the employee’s HSA could not exceed 9/12 of the annual HSA contribution limit. However, under the 2006 law, even if the employee does not become eligible until April 1, contributions of up to 100% of the annual limit may be made to the employee’s HSA. Thus, employers in this situation should weigh the pros and cons of allowing rollovers of FSA balances that would otherwise be forfeited (e.g., consider the size of account balances available during the grace period) with simply letting participants make their full contribution when finally eligible after the end of the grace period.

Employers with HRAs. Employers that sponsor HRAs face different considerations. Unlike health FSAs, many HRAs provide for a carryover of the balance from year to year. This means that unless the HRA is changed to be HSA-compatible for all participants, employees may be precluded from becoming HSA-eligible until the end of the plan year in which they no longer have an HRA balance. For these employees and for employers who want to transition from HRAs to HDHP/HSA programs, the rollover option may be very attractive.

The Zero Balance Requirement

As noted above, the new law allows coverage during a health FSA grace period or HRA coverage that would otherwise preclude HSA eligibility to be disregarded if the balance in the health FSA or HRA at the end of the preceding plan year is zero. According to the notice, if an individual has a zero balance in a health FSA with a grace period on the last day of the plan year, the FSA coverage during the grace period is disregarded in determining HSA eligibility.

For a general purpose HRA, the coverage of an individual with a zero balance on the last day of the HRA plan year will be disregarded only if one of the following conditions is met –

- The employee elects to waive participation in the HRA effective on the first day of the immediately following HRA plan year.
- The employer terminates the general purpose HRA with respect to all employees effective on or before the first day of the following HRA plan year.
- The employer converts the general purpose HRA to an HSA-compatible HRA with respect to all employees effective on or before the first day of the following HRA plan year.

Balances are determined on a cash basis as described above.
Conclusion

Notice 2007-22 provides important guidance on how employers may reduce the impact that health FSA grace periods and HRA carryover balances may have on HSA eligibility. However, the rules for making rollovers are complex and many employers, particularly those that sponsor health FSAs, may determine that they do not want to permit them.

Buck’s consultants would be pleased to discuss the latest guidance with you and help you determine whether HSA rollovers are appropriate for your situation.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.