

## NEW GUIDANCE CLARIFIES CHANGES TO HSA CONTRIBUTIONS MADE BY THE TAX RELIEF AND HEALTH CARE ACT OF 2006

### BACKGROUND

The Medicare Prescription Drug Improvement and Modernization Act of 2003 (*Public Law. 180-173, Dec. 8 2003*) added Internal Revenue Code Section 223 creating Health Savings Accounts (HSAs). HSAs are individually owned savings accounts used to pay current and future qualified medical expenses. Eligible individuals<sup>1</sup> with qualified High Deductible Health Plan (HDHP) coverage may establish and contribute to HSAs. Code Section 223 provides for favorable treatment of HSA contributions and tax-free distributions for qualified medical expenses.

In late 2006, Code Section 223 was amended by the passage of the Tax Relief and Health Care Act (the Act) for calendar years beginning 2007 and beyond. In particular, the Act enhanced provisions regarding HSA contributions. The Internal Revenue Service recently released Notice 2008-52 addressing the contribution provisions under the Act. The following summarizes key points of this notice. A link to the text of Notice 2008-52 is available at <http://treas.gov/offices/public-affairs/hsa/pdf/n-08-52.pdf>.

### DEDUCTIBLE LIMIT ON HSA CONTRIBUTIONS REPEALED

The Act repealed the “lesser of” requirement associated with HSA contributions between 2004 and 2006.<sup>2</sup> For 2007 and beyond, the maximum amount that may be contributed to an HSA is based on the indexed statutory maximums without regard to the deductible. For 2008 those amounts are \$2,900 for self-only coverage and \$5,800 for family coverage.

### ANNUAL HSA CONTRIBUTION LIMIT FOR 2007 AND LATER YEARS

If an individual is HSA eligible on the first day of the last month of the individual's taxable year (December 1 for calendar year taxpayers), the individual's maximum HSA contribution for the year is the **greater** of the following:

1. The sum of the statutory limits determined separately for each month based on eligibility and HDHP coverage on the first day of each month, plus catch-up

<sup>1</sup> An eligible individual 1) must have qualified high deductible health plan (HDHP) coverage on the first day of the month, 2) must not be covered by any other non-HDHP health plan, 3) is not entitled to benefits under Medicare, and 4) may not be claimed as a dependent on another person's tax return. *Code 223(c)(1); Notice 2004-2; 2004-2 I.R.B 269.*

<sup>2</sup> Prior to 2007, the maximum HSA contribution was the lesser of the amount of the high deductible under the HDHP or the statutory maximum.

- contributions for each month (if applicable) (**Sum of Monthly Contributions Rule**);  
or
2. The maximum statutory HSA contribution based on the individual's HDHP coverage on the first day of the last month of the individual's taxable year, plus catch-up contributions if applicable. (**Full Contribution Rule**)

#### Sum of the Monthly Contribution Limit Rule

The maximum annual contribution to an HSA is the sum of the monthly statutory contribution limits, based on HSA eligibility and HDHP coverage. Generally this limit is 1/12 of the indexed amount under the statute. This monthly amount may be increased for individuals eligible to make catch-up contributions<sup>3</sup>. The catch-up contribution is also computed on a monthly basis. If an individual is not HSA eligible on December 1 of the taxable year, then the maximum contribution limit will be determined under this formula.

#### Full Contribution Rule

An individual who is eligible on the first day of the last month of the taxable year (December 1 for calendar year taxpayers) will be treated as having been an eligible individual for the entire year, and therefore may increase (but not decrease) their annual contribution limit. The guidance states that the individual will be treated as enrolled in the same HDHP coverage (self-only or family coverage) as he or she had on the first day of the last month of the calendar year. For example, an individual who enrolls in family QHDHP on December 1, 2008 will be treated as an eligible individual with family coverage for all twelve months of 2008. (*See also example 3 below.*) The rule also applies to catch-up contributions. However, in order to avoid adverse tax consequences, the Full Contribution Rule requires individuals to remain HSA eligible during the Testing Period.

#### Testing Period

The Testing Period begins on the first day of the last month of the taxable year and ends on the last day of the 12<sup>th</sup> month following that month. Thus, for 2008 HSA contributions, the Testing Period is December 1, 2008 – December 31, 2009. An individual will need to remain HSA eligible throughout the testing period in order to avoid tax implications under the Full Contribution Rule. Changing between levels of qualified HDHP coverage (i.e. move from single HDHP to family HDHP) will not impact an individual's eligibility during the Testing Period.

If, under the Full Contribution Rule, the individual makes an HSA contribution greater than the sum of the monthly contribution limit and does not remain HSA eligible during the Testing Period, the additional contribution is included in the individual's gross income and is subject to an additional 10% tax. The amount is calculated by subtracting the sum of the monthly contribution limits that the individual would otherwise have been entitled to from the amount actually contributed. The 10% tax applies in all cases, regardless of age, except death and disability of the individual. An individual is not required to withdraw the extra contribution from the HSA; withdrawing those funds could trigger additional tax implications. Furthermore, earnings on the additional amounts are not included in gross income or subject to the penalty tax so long as the earnings remain in the HSA or are used for qualified medical expenses.

Additionally, the guidance states that employers and trustees are not responsible for reporting whether an individual remains HSA eligible during the Testing Period.

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<sup>3</sup> A catch up contributions is available to individuals age 55 an older who are covered by an HDHP. They may make catch contributions each year until they enroll in Medicare. *Code 223b(3)* For 2008 individuals may make up to \$900 in catch-up contributions.

### *Example 1*

Adam, age 53, enrolls in family HDHP coverage on December 1, 2008 and is otherwise eligible. Adam was not HSA eligible in any other month in 2008 (other than December). What is the maximum amount that Adam can contribute to his HSA for 2008?

Under the Full Contribution Rule, Adam may contribute \$5,800. The sum of his monthly contributions limits is \$483.33 ( $1/12 \times \$5,800$ ) which is less than the \$5,800. Adam is subject to the Testing Period.

### *Example 2*

Same as Example 1, but assume Adam contributes \$5,800 and loses HSA eligibility on June 1, 2009

The Testing Period for Adam's 2008 contributions is December 1, 2008-December 31, 2009. He becomes HSA ineligible June 1, 2009. Therefore Adam must include in gross income \$5,316.67, the amount contributed to the HSA for 2008 minus the sum of the monthly contributions limits ( $\$5,800 - \$483.33$ ). In addition, the 10% additional tax applies to the amount included in gross income (\$531.67).

### *Example 3*

Bob, age 39, enrolls in self-only HDHP coverage on January 1, 2008 and is an eligible individual on that date. Bob's coverage changes to family HDHP on November 1, 2008 and remains by family HDHP on December 1, 2008.

Bob contributed \$3,383.34 during 2008 ( $\$2,416.67 + 966.67$ )<sup>4</sup>. Under the Full Contribution Rule Bob may contribute the greater of the sum of his monthly contributions (\$3,383.34) or the full contribution amount based on this coverage on the first day of the last month of the taxable year (\$5,800). Bob has family coverage on December 1, 2008 and therefore may contribute up to \$5,800.

### Full Contribution Rule & the Health FSA with a Grace Period<sup>5</sup>

The guidance clarifies that an individual, who is ineligible for purposes of the HSA due traditional health FSA coverage during the grace period, may nevertheless contribute the full annual contribution without adverse tax consequences provided he or she is HSA eligible on December 1 and remains eligible during the Testing Period.

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<sup>4</sup> Monthly contributions are based on 10 months single coverage ( $10/12 \times \$2,900 = \$2,416.67$ ) plus 2 months of family coverage ( $2/12 \times \$5,800 = \$966.67$ ).

<sup>5</sup> Generally, a traditional health FSA grace period will be disqualifying non-HDHP coverage. This means an individual is not HSA eligible until the expiration of the 2 month and 15 day grace period. See *Notice 2005-86*. However, the Act provides for a special rule where a traditional FSA grace period will not be disqualifying HSA coverage if at the end of the prior FSA plan year the balance in the FSA was \$0 or if the individual made a qualified FSA rollover to the HSA as of the last day of the plan year. Code 223(c)(1)(B)(iii). See also *Kibble & Prentice Technical Bulletin* at: <http://www.kpcom.com/newsletters/documents/TransformationofHSAin2007.pdf>.

#### *Example 4*

In 2007 Carrie is covered by a general purpose health FSA with a grace period ending on March 15, 2008. Carrie enrolls in family HDHP coverage on January 1, 2008 but is ineligible for purposes of the HSA until April 1, 2008. On April 2, 2008 Carrie contributes \$5,800 to her HSA for 2008. She remains covered by the HSA on December 1, 2008 and through the Testing Period.

Carrie is an eligible individual with family HDHP coverage on December 1, 2008. She may contribute the greater of her full contribution amount (\$5,800) or the sum of her monthly contributions ( $9/12 \times \$5,800 = \$4,350$ ). Carrie contributed \$5,800 to her HSA for 2008. Further, because she remains HSA eligible through her Testing Period, she will not have an income tax inclusion or penalty tax.

If Carrie lost HSA eligibility on June 1, 2009, then \$1,450<sup>6</sup> would be included as income and a 10% penalty (\$145) would apply.

#### **EXCESS CONTRIBUTIONS**

The Excess Contributions Rule imposes a 6% excise tax for each taxable year on HSA contributions in excess of the maximum contribution limit for the year. However, a taxpayer may avoid the 6% excise tax by withdrawing the excess contribution prior to the federal income tax filing deadline (with extensions). The guidance states that an amount included in income because an individual failed to remain eligible during the Testing Period is not an excess contribution and therefore cannot be withdrawn under this provision.

#### **HSA DISTRIBUTIONS NOT USED FOR QUALIFIED MEDICAL EXPENSES**

HSA distributions used for nonqualified medical expenses are included in gross income and subject to the 10% tax, subject to certain exceptions.<sup>7</sup> This rule applies regardless of whether the individual receiving the nonqualified distribution previously included the amount as income for failing to satisfy the Testing Period.

#### **ESTABLISHING HSAs**

An individual may establish an HSA at any time on or after the day he or she is HSA eligible. Contributions to the HSA for the taxable year may be made in one payment, or multiple payments, at any time prior to the federal income tax filing return deadline (without extension).

Expenses incurred prior to the establishment of the HSA are not qualified medical expenses. Even if an individual takes advantage of the Full Contribution Rule, an otherwise eligible expense incurred prior to the establishment of the HSA would not be a qualified medical expense. Therefore, an HSA distribution for a nonqualified expense would be taxable as income and subject the applicable penalty tax.

#### *Example 5*

Joe, 30, establishes an HSA on December 1, 2008 with self-only coverage and contributes \$2,900 to the HSA on December 7, 2008. May an otherwise eligible medical expense Joe incurred on May 1, 2008 be reimbursed tax-free by the HSA?

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<sup>6</sup> ( $\$5,800 - \$4,350$ ) = \$1,450

<sup>7</sup> The 10% penalty tax does not apply in the case of death, disability or distributions made after Medicare eligibility. Code 223(f)

The answer is no. Only qualified medical expenses incurred on or after December 1, 2008 are eligible for a tax-free distribution from the HSA. If Joe received a distribution from his HSA for this expense, it would be included as income and subject to the 10% penalty.

## **Conclusion**

The Full Contribution Rule is beneficial in many scenarios, including individuals with less than twelve months of eligibility and individuals that change HDHP coverage levels mid-year. Provided an individual is HSA eligible December 1 of the taxable year, he or she may make the full HSA contribution based on their HDHP coverage on Dec 1. However, be mindful of the potential tax ramifications when HSA eligibility is not maintained through the Testing Period. This is particularly important when implementing an HDHP off a calendar year cycle, as covered individuals will not likely have a full twelve months of qualified coverage. If individuals are concerned about retaining HSA eligibility during the Testing Period, they may be better served to make the maximum monthly contribution for each month of HSA eligibility as opposed the full contribution. While this design would result in lower contributions than under the Full Contribution Rule, it would avoid triggering the Testing Period and potential income tax inclusion should the individual lose eligibility in the following twelve months.

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