

Qualified HSA Distributions from an FSA with a Grace Period and an HRA

The IRS issued Notice 2007-22 providing guidance on qualified HSA distributions (or rollovers) of funds from a health FSA or HRA to a HSA. This guidance provides limited clarification to the rollover provision as established by the Tax Relief and Health Care Act of 2006, passed December 20, 2006. The following summarizes key points from the guidance.

Highlights:

- Rollovers (qualified HSA distributions) are only permissible if they are from an FSA WITH A GRACE PERIOD or an HRA. Funds from an FSA with NO grace period may not be rolled into an HSA. (See discussion below.)
- Rollovers are optional. If an employer wants to offer this option, the employer must amend plan documents.
- FSAs with grace periods and HRAs ending in 2006 must move quickly if the employer wants to provide rollovers. There are a number of steps that must be accomplished and the deadline is March 15, 2007.

Important Clarifications:

To start, the guidance provides clarification on some outstanding questions:

NO QUALIFIED DISTRIBUTIONS FOR FSA PLANS WITHOUT A GRACE PERIOD

An individual covered by a general purpose health FSA without a grace period may not take advantage of a HSA qualified distribution. The guidance expressly states that the amendment to the Act does not change the rule that unused amounts remaining in the health FSA at the end of the plan year must be forfeited in the absence of a grace period. Therefore, any unused amounts remaining in the health FSA at the end of the plan year with no grace period remain subject to the “use it or lose it” rule.

Additionally, if the funds were rolled over prior to the end of the plan year, the individual has disqualifying HSA coverage since they would remain covered by a general purpose health FSA until the end of the plan year. Such a distribution would be subject to income tax and the additional 10% penalty.

INDIVIDUALS NOT COVERED BY HEALTH FSA ON SEPTEMBER 21, 2006

The guidance states individuals who were not covered by a health FSA with a grace period or HRA on September 21, 2006 are not eligible to make a qualified HSA distribution.

INDIVIDUALS COVERED BY A DIFFERENT FSA FOLLOWING SEPTEMBER 21, 2006

Individuals, who were covered by one employer's FSA with a grace period on September 21, 2006 but moved to another employer's FSA at a later date will not be eligible to make a qualified HSA distribution from the FSA of their former employer.

General Rules

PAST

- An individual with general purpose health FSA or HRA coverage was not HSA eligible.
- A health FSA with a grace period (even if the health FSA has a \$0 balance in the grace period) was disqualifying coverage. An individual would not be HSA eligible until the first of the month following the expiration of the grace period (provided the individual was otherwise eligible.)

NEW RULE (TAX YEARS BEGINNING AFTER DECEMBER 31, 2006)

- Coverage by a health FSA with a grace period will be disregarded for purposes of HSA eligibility if the year-end balance in the FSA is \$0 or if the individual makes a qualified HSA distribution of the remaining balance at year end.
- An individual with coverage under a general purpose HRA can become HSA eligible provided the balance in the HRA is \$0 at plan year end, or the individual makes a qualified HSA distribution of the remaining balance at year end.

THE QUALIFIED HSA DISTRIBUTION (ROLLOVER)

Qualified HSA distributions, or rollovers, are a plan design choice. If an employer chooses to offer the employees a rollover from their Health FSA with a grace period or an HRA, the employer must amend the written plan documents. The employer may not discriminate as to who may rollover funds. If made available, any otherwise eligible individual with a qualified High Deductible Health Plan (HDHP) coverage may elect to rollover their funds.

The amount of the qualified HSA distribution from a health FSA with a grace period or an HRA is the lesser of the balance on 1) September 21, 2006 or 2) the balance on the date of the distribution. The balance in the account is determined on a cash basis. The guidance defines a cash basis as accounting for expenses incurred and paid under the plan. Pending claims, claims submitted, claims received or claims under review are disregarded in determining the balance in the FSA or HRA account.

The HSA qualified distribution must be contributed directly to the HSA trustee. To avoid tax consequences, the individual making the qualified distribution must remain HSA eligible during the testing period. The testing period is defined as the 12-month period following the month of the distribution. The consequences for failing to remain HSA eligible include having taxable income in the amount of the distribution plus a 10% penalty tax.

HDHP coverage must be in place on the first of the month in which the rollover is made. The individuals must not have other non-HDHP coverage (disqualifying coverage) at this time.

THE TRANSITION RULE

For employers desiring to take advantage of the rollover provision between December 31, 2006 and March 15, 2007, all of the following must be satisfied:

1. Employer must amend the health FSA with a grace period or HRA plan effective on or before March 15, 2007 to allow rollovers;
2. No previous rollover from the particular health FSA with a grace period or HRA can be made on behalf of the employee;
3. Employee has HDHP coverage as of the first of the month in which the rollover occurs and is otherwise eligible;
4. Employee elects to make a rollover on or before March 15, 2007
5. Rollover does not exceed the lesser of the balance on September 21, 2006 or date of the rollover;
6. Employer makes the rollover directly to the HSA trustee by March 15, 2007, but after the employee is HSA eligible; and
7. Either –
 - a. Rollover results in a \$0 balance in the health FSA with a grace period or HRA and the employee is no longer a participant in any non-HSA compatible health plan; or
 - b. Effective on or before the date of the first rollover, the health FSA with a grace period or the HRA is converted to an HSA compatible health FSA or HRA for all participants.

EXAMPLES OF THE TRANSITION RULE- FROM NOTICE 2007-22

Employee M

Facts: Employee M has a balance of \$850 in a health FSA with a grace period on December 31, 2006. On or before December 31, 2006, M elects HDHP coverage beginning January 1, 2007. M does not elect to have a qualified HSA distribution of the \$850 remaining in the health FSA on December 31, 2006. M incurred \$850 of § 213(d) expenses after January 1 and the health FSA reimbursed M for that amount. M's health FSA balance is zero on January 22, 2007. M is otherwise an eligible individual as of January 1, 2007.

Application: Employee M did not have a \$0 balance in a health FSA with a grace period at the end of the plan year (December 31, 2006). M did not make a rollover of the FSA balance by March 15, 2007. Therefore, M remained covered by a general purpose FSA with a grace period, which is disqualifying HSA coverage. M is not HSA eligible until April 1, 2007; the month following the expiration of the grace period.

Employee N

Facts: Employee N has a balance of \$800 in the health FSA with a grace period on September 21, 2006, and a balance of \$200 on December 31, 2006. On or before December 31, 2006, N elects HDHP coverage beginning January 1, 2007. During January 2007, the health FSA reimburses N for \$50 in § 213(d) medical expenses. On February 12, 2007, N elects to have a qualified HSA distribution of the remaining health FSA balance of \$150. Employer S contributes \$150 to an HSA on behalf of N on or before March 15, 2007. N is otherwise an eligible individual as of January 1, 2007.

Application: N makes a qualified distribution on February 12, 2007 of the balance in this 2006 FSA with a grace period. N has a \$0 balance in the FSA with a grace period following a qualified distribution on or before March 15, 2007. Under the special transition rule N is HSA eligible January 1, 2007.

Employee O

Facts: Employee O has a balance of \$300 in the health FSA with a grace period on September 21, 2006, and a balance of \$175 on December 31, 2006. On or before December 31, 2006, O elects HDHP coverage for 2007. On or before March 15, 2007, O also elects to have a qualified HSA distribution of the \$175 remaining in the health FSA on December 31, 2006. Employer S contributes \$175 to an HSA on behalf of O on or before March 15, 2007. O is otherwise an eligible individual as of January 1, 2007.

Application: O is an eligible individual as of January 1, 2007, because after the qualified HSA distribution O has a zero balance in a health FSA.

PERMANENT RULE

For plans that fall outside of the transition rule, the IRS provided some initial guidance on establishing qualified HSA distributions from a health FSA with a grace period and an HRA. The rules are the same as those outlined above with the following differences:

1. Employer must amend the plan documents by the last day of the plan year in order to permit a qualified HSA distribution;
2. Employee elects to make a qualified HSA distribution by the last day of the plan year;
3. The health FSA with a grace period or HRA does not reimburse the employee for any expense after the last day of the plan year; and
4. Employer makes the qualified HSA distribution to the HSA trustee by the 15th day of the third calendar month following the end of the plan year, but after the employee is HSA eligible.

CONCLUSION

There remain many unanswered questions from this guidance with respect to qualified HSA distributions. The IRS Notice indicates that additional guidance will be released to provide further clarification for qualified HSA distributions from health FSAs with a grace period and HRAs. As additional guidance becomes available, we will communicate it to you. Should you want to implement a qualified HSA distribution for 2006 balances it is important that you contact your FSA or HRA administrator and begin the plan document amendment process. Again, all of the steps must be completed by March 15, 2007.

RESOURCES

1. IRS Notice 2007-22 (<http://www.irs.gov/pub/irs-drop/n-07-22.pdf>)
2. IRS Notice 2005-42 (http://www.irs.gov/irb/2005-23_IRB/ar11.html)
3. Tax Relief & Health Care Act 2006; Section III