

Complicated Guidance Issued on Rollovers to Health Savings Accounts

March 12, 2007

The IRS recently issued Notice 2007-22 (the Notice), which provides guidance on new rollover rules applicable to Health Savings Accounts (HSAs) under the Tax Relief and Health Care Act of 2006. The Notice is complicated and full of traps for the unwary, and it offers the “reward” of double taxation for mistakes. The Notice also offers a transition rule for 2006 that expires on March 15, 2007 and is, for a number of reasons, of very limited use for employers and participants.

The Notice implements one part of the surprise HSA legislation passed in the waning hours of the 109th Congress and signed by President Bush on December 20, 2006. For a broader discussion of the legislation, [please click here](#).

Specifically, the Notice addresses the requirements for making a tax-free rollover from a Health Reimbursement Arrangement (HRA) or a health Flexible Spending Account (FSA) with a grace period to an HSA. The purpose of this rollover is to allow employers and participants to transfer during the years 2007 through 2012 (each, a “Transfer Year”) a balance from an HRA or FSA to an HSA and also to ease the transition to an HSA-only environment. The Notice also creates rules of broader application, including guidance for determining when an individual has a zero balance in an FSA or an HRA, how to apply the additional 10% tax for HSA violations, and reporting rules for HSA rollovers.

Rollovers

The Notice explains the limited circumstances under which a participant can elect a one-time tax-free rollover of the balance in his or her HRA or FSA to an HSA. In addition to smoothing the transfer from an HRA/FSA to an HSA environment, the tax-free rollover is not limited by the annual caps on what can be contributed to an HSA. Thus, in the limited circumstances in which the rollover rules apply, this election provides a powerful opportunity to quickly boost an individual’s balance in an HSA.

The rollover must occur no later than December 31, 2012. Only one rollover can occur per HRA or FSA. In order to accomplish the rollover:

- The HRA/FSA must be amended by year-end of the relevant Transfer Year to permit the rollover for all eligible individuals;

- The participant must elect the rollover by year-end of the relevant Transfer Year (and must not have previously elected a rollover from the HRA/FSA);
- The year-end balance must be frozen (on a cash basis determined in accordance with the Notice) so that no reimbursements are made after year-end of the Transfer Year;
- The amount transferred cannot be more than the lesser of (a) the September 21, 2006 balance or (b) the balance at year-end of the Transfer Year;
- The transfer must generally result in a zero balance in the HRA/FSA;
- The employer must make a direct transfer to the custodian of the HSA by March 15 of the year immediately following the Transfer Year; and
- The participant must remain HSA-eligible for the 12-month period following the month of the rollover.

These requirements come wrapped with a number of subtle additional issues and timing requirements and can easily be violated. If a rollover fails to meet the Notice requirements, the amount of the rollover will be taxable income to the participant and is also subject to an additional 10% tax under new Internal Revenue Code section 106(e)(3). This taxed amount does not establish a basis in the HSA and will result in subsequent taxation of any HSA amounts that are used for nonqualified medical expenses.

Among the many ways that the rollover can go wrong are if the rollover is based on a balance other than the year-end balance, if the FSA does not have a grace period, if the participant is not an eligible HSA participant at the time of the transfer, or if the participant continues to participate in a general purpose HRA/FSA.

A very limited transition rule permits HRA/FSA rollovers by March 15, 2007 without the need to have frozen the HRA/FSA balance as of December 31, 2006. However, all the other steps (including the election, amendment, transfer, and so forth) must be completed by March 15, 2007. Given that the 2007 open enrollment period ended before the rollover opportunity even sprang to life, few individuals with otherwise disqualifying HRA/FSA funds would have enrolled in a high-deductible plan/HSA combination for 2007. Further, given the timing of HSA eligibility rules, an individual would have to be enrolled in a high-deductible plan as of March 1, 2007 in order for a rollover to take place by March 15, 2007. Due to these realities, the transition is of little practical use, and most rollovers will instead take place at the end of 2007 or in later years.

Despite the tightly constrained opportunities presented by the Notice, employers with large HRA accumulations may consider taking advantage of the rollover opportunity. While this means turning a future liability into a current cash expense, and also losing control of whether the funds are used solely for medical expenses, the Notice does describe a way out of an HRA environment. This exit strategy may become very important if President Bush's budget proposals eliminating HRAs/FSAs gain traction in the new Congress.

Morgan Lewis attorneys have advised many employers on HRA, FSA, and HSA issues and would be happy to help you examine the details of the Notice and how the Notice can help you move from an HRA/FSA into a high-deductible health plan paired with an HSA. For more information on the Notice, please contact one of the following Morgan Lewis attorneys:

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