

July 10, 2008

**MEMORANDUM TO CLIENTS**

**Re: Recent IRS Guidance on Health Savings Accounts**

The Internal Revenue Service recently issued three notices providing guidance on Health Savings Accounts ("HSAs"). The guidance addresses rollovers to HSAs from IRAs and Roth IRAs, HSA contribution limits, and various technical questions about many aspects of HSAs. The three notices are summarized below.

**I. Background on Health Savings Account**

An HSA is an account, similar to an IRA, to which individuals under age 65 and/or employers may make annual contributions within specified limits. The earnings in the account grow on a tax-free basis, and, if used for medical expenses, may be withdrawn on a tax-free basis. When an individual becomes Medicare-eligible, or in the event of death or disability, amounts in the account may be used for any purpose without incurring a tax penalty (although these amounts must be included in income).

In order for an individual to contribute to an HSA or have contributions made on an individual's behalf, the individual must be covered under a high deductible health plan ("HDHP"), and may not participate in any other health plan that has a lower deductible, subject to certain exceptions.

**II. Notice 2008-51**

The Tax Relief and Health Care Act of 2006 (the "TRHCA") contained a provision that permits an individual to make a one-time tax-free distribution from an IRA or Roth IRA (herein out, "IRA") to his or her HSA. Such distributions may not be made from an individual's ongoing SIMPLE or SEP IRA. A qualified IRA-to-HSA contribution ("qualified funding distribution") is excluded from an individual's gross income provided that the individual is an "eligible individual" under the HSA rules. Such a qualified funding distribution also is not subject to the 10% additional tax imposed on early IRA withdrawals by §72(t) of the Internal Revenue Code ("IRC"). Individuals are permitted to make qualified funding distributions from IRAs to HSAs in taxable years beginning after December 31, 2006. New Notice 2008-51 provides guidance on how this new provision operates.

**A. Eligibility and the "Testing Period"**

To qualify for this favorable tax treatment, the IRA-to-HSA transfer must satisfy several conditions. The individual making the transfer must be an "eligible individual" under IRC §223(c). Generally, an eligible individual is one covered by an HDHP. The individual making the transfer must remain eligible during the entire "testing period" following the date of the

qualified funding distribution. The testing period begins in the month during which the transfer is made and continues for twelve additional months. For example, if a qualified funding distribution is made on July 15, 2008, the testing period would extend from July 2008 to July 31, 2009.

If at any time during the testing period the individual is no longer an eligible individual, the qualified funding distribution loses its favorable tax treatment. The qualified funding distribution would be included in the individual's gross income for the taxable year in which the individual first fails to be eligible, and also would be subject to a 10% additional tax. Neither penalty is incurred, however, if the individual loses his or her status as an eligible individual because of disability or death.

A beneficiary to an IRA can make a qualified funding distribution using the inherited funds to his or her own HSA upon the death of the original IRA owner. A qualified funding distribution cannot be made to an HSA owned by any other person, including that individual's spouse.

**B. Maximum Amount of Contribution and Procedures for Making the Transfer**

A qualified IRA-to-HSA funding distribution cannot exceed the maximum annual amount allowed for HSA contributions, but it can be less than the maximum annual contribution limit. The maximum annual contribution amount is determined based on the individual's HDHP coverage (family or self-only HDHP coverage) and the individual's age. For 2008, an eligible individual with self-only HDHP coverage is allowed an HSA contribution of \$2,900, and an eligible individual with family HDHP coverage is allowed an HSA contribution of \$5,800. For 2009, these amounts increase to \$3,000 and \$5,950 respectively. Individuals age 55 or older are also allowed a "catch-up contribution" in addition to these set maximums to count toward the maximum amount of the transfer. The catch-up contribution amount is \$900 for 2008, and \$1,000 for 2009.

A qualified funding distribution from an IRA to an HSA is not allowed as a deduction on the individual's income tax return.

If the amount transferred from the IRA to the HSA exceeds that individual's maximum annual HSA contribution amount, the amount in excess of the maximum contribution amount becomes subject to the usual penalties for excess HSA contributions. For example, if an individual whose maximum allowable HSA contribution is \$5,800 contributes \$10,000 in an IRA-to-HSA transfer, then \$4,200 is an excess HSA contribution and subject to the rules under IRC § 223 for excess contributions. Therefore, the excess amount is taxable and subject to a 10% additional tax.

If an individual with self-only HDHP coverage makes a qualified funding distribution, and then obtains family HDHP coverage within the same taxable year, that individual is allowed a second qualified funding distribution during that year. The aggregate of both contributions cannot exceed the maximum annual HSA contribution allowed to those with family HDHP

coverage. This is the only exception to the "once per lifetime" rule for qualified funding distributions.

When an individual downgrades from family HDHP coverage to self-only HDHP coverage, that individual's maximum annual contribution amount remains that of an eligible individual with family HDHP coverage for that entire taxable year. An eligible individual's maximum annual HSA contribution is based on the age of the individual at the end of the taxable year and the type of HDHP coverage in place at the time of the qualified funding distribution.

A qualified funding distribution must be made in a direct transfer from an IRA to an HSA. A check from an IRA made payable to the HSA trustee or custodian and delivered by the IRA owner to the HSA trustee or custodian would be considered a direct transfer from an IRA to an HSA. An individual wishing to make an HSA contribution from multiple IRAs must transfer the desired amount to a single IRA and then make the qualified funding distribution from that single IRA. Separate transfers from separate IRAs would not be allowed.

### **C. Testing Period Issues**

The TRHCA also provided that an individual who was enrolled in a HDHP in the last month of the tax year could make a cash contribution to his or her HSA as if the individual was enrolled in the HDHP for the entire year, provided that the individual remained enrolled in the HDHP during the 12-month testing period (discussed in more detail later this memo). This is a different testing period rule than the one that applies to IRA qualified funding distributions. If an individual makes both an IRA and basic cash contribution to his or her HSA within the same taxable year, there is no interplay between the testing periods for each type of contribution. Failure to maintain eligibility with respect to the IRA transfer does not affect eligibility with respect to the cash contribution, and vice-versa. Each contribution is subject to its own independent testing period and Notice 2008-51 provides special rules for determining the tax implication if one testing period is met in a year, but not the other.

## **III. Notice 2008-52**

As a companion to Notice 2008-51, the IRS also issued Notice 2008-52. Notice 2008-52 provides guidance on the implementation of the provisions in TRHCA that describe changes to the annual HSA contribution limits. The guidance also clarified that an individual may establish an HSA anytime on or after the individual becomes HSA eligible. The changes became effective for plan years beginning on and after 2007.

### **A. Annual Contribution Limit Increased by TRHCA**

The annual HSA contribution limit was increased by TRHCA to equal the greater of either:

- (1) the annually indexed maximum contribution set by Department of Treasury based on the level of HDHP coverage (self-only or family) on the first day of the last month of the taxable year (i.e. December 1) or

- (2) the sum of the monthly contribution limits based on eligibility and level of HDHP coverage.

Previously, the annual HSA contribution limit was statutorily limited to the lesser of either the deductible on a participant's HDHP or the annually indexed maximum. Prior to TRHCA, an individual who was first enrolled in HDHP coverage on December 1<sup>st</sup> could only contribute and deduct the monthly contribution limit based on eligibility and level of HDHP coverage.

The increase means that for 2008, eligible HSA participants enrolled on December 1<sup>st</sup> in self-only HDHP coverage can contribute up to \$2,900 (or, if greater, their monthly contribution limit) and participants enrolled in family HDHP coverage on December 1<sup>st</sup> can contribute up to \$5800, plus any catch-up contributions for eligible individuals without regard to the HDHP deductible.

#### **B. Full-Year Contribution Rule & Testing Period**

As mentioned previously, under new full year contribution provisions of TRHCA, an individual who is eligible to make an HSA contribution on the first day of the last month of the taxable year (i.e. December 1) by being enrolled in a HDHP is now permitted to make a full annual contribution plus any applicable catch-up contributions. To take advantage of the full year contribution rule, the individual must remain an eligible individual through a "testing period."

The testing period begins the first day of the last month of the taxable year (i.e. December 1) and ends the last day of the 12th month following that month (i.e. the following December 31st). For example, if an individual enrolls in a self-only HDHP on December 1, 2008 and under the full-year contribution rule makes the full contribution of \$2,900, the individual must remain HSA eligible until December 31<sup>st</sup>, 2009. Changing HDHP coverage levels mid year—from family to self-only coverage or vice versa—will not affect HSA eligibility for purposes of the testing period.

Individuals who become HSA eligible mid-year, who elect not to take advantage of or are not eligible for the full year contribution rule, can elect to make contributions only for the months during which they were eligible. Eligibility is determined on a monthly basis on the first day of each month. The monthly contribution limit (including the catch-up contribution) is 1/12 of the annual applicable contribution limit. For example, if an individual with family HDHP coverage is HSA eligible only in September and October, the individual would be eligible to contribute up to \$966.67 (i.e. 5,800/ 12 x 2 months of family HDHP coverage with no catch-up contribution).

For individuals who change HDHP coverage levels mid-year, the contribution amount would also be determined on a monthly basis. For example, if an HSA eligible individual enrolls in self-only HDHP coverage on January 1, 2008, but then changes to family HDHP coverage on November 1, 2008 and remains eligible through December 31, 2008, such individual would be eligible to contribute \$5,800. The \$5,800 is the greater of annual family HDHP contribution (based on December 1<sup>st</sup> HDHP coverage) or the monthly contribution limit of \$3,383.34 ( $(\$5800/12 \times 10) + (\$2900/12 \times 2) = \$3,383.34$ ).

If an individual fails to remain eligible during the testing period, the additional HSA contributions are included in gross income and subject to an additional 10% tax. The penalty will not apply if the failure is due to death or disability. The contribution amount subject to the penalty is calculated by subtracting the amount the individual would have been entitled to if they had not made the full year contribution (i.e., the monthly contribution limit multiplied by the months covered by the HDHP) from the amount actually contributed. Amounts subject to the test-period penalty are not eligible to be withdrawn as an excess contribution under Code § 223. A 6% excise tax is imposed on all contributions in excess of the maximum contribution limit.

#### **IV. Notice 2008-59—HSA "Grab Bag" Guidance**

Notice 2008-59 is in the form of forty-two questions and answers in seven different topic areas – that's why its called the "grab bag". The guidance, which covers issues on such topics as eligibility, contributions, and distributions from HSAs, outlines some of the general principles regarding HSAs and provides many specific examples which should be helpful in answering questions that employers and employees have about HSAs.

##### **A. Eligible Individuals**

Notice 2008-59 addresses specific circumstances where an individual is or is not an eligible individual based on types of health coverage the individual is has and satisfaction of deductible limits. As discussed above, an individual is an eligible individual if the individual is covered under an HDHP and no other health plan below that deductible except for disregarded coverage or preventive care. The HDHP must have certain minimum deductible amounts which increase annually. For 2008, the minimum deductible amount for self-only HDHP coverage is \$1,100, and the minimum deductible amount for family HDHP coverage is \$2,200. For 2009, these amounts increase to \$1,150 and \$2,300 respectively.

Notice 2008-59 discusses the effect of other health coverage on an individual's status as an eligible individual. Examples are provided that illustrate the rules on the types of other health coverage that may be maintained yet still let an individual be eligible to make HSA contributions. For example, an individual may be covered by a Health Reimbursement Arrangement ("HRA") that pays or reimburses premiums for the employer-sponsored HDHP and still be an eligible individual even though that premium payment occurs prior to the high deductible limit being met. However, an individual will not be an eligible individual if a post-deductible HRA pays expenses of a spouse before the minimum family HDHP deductible is satisfied. The Notice also clarifies that an individual who is enrolled (not merely eligible to enroll) in Medicare, including being enrolled in Medicare Part D, is not eligible to make HSA contributions.

If an employer provides a free health care clinic at the employer's premises that does not automatically mean that the employees are ineligible to make HSA contributions. The Notice gives an example of what types of services provided in the clinic will make the employees ineligible, such as providing the full range of medical services as a hospital would. Presumably, if a payment was required by the clinic for the medical services provided, the clinic would not

make an individual ineligible to make HSA contributions. However, there is no discussion in the Notice of this or of what the clinic must charge the employees in order for them to still be eligible to make HSA contributions.

The Notice also discusses the application and satisfaction of the minimum HDHP deductible amounts. The guidance makes clear that an individual must satisfy the statutory minimum HDHP deductible himself or herself to remain an eligible individual. For example, an individual will not be an eligible individual if an employer pays or reimburses medical expenses of the employee before the statutory minimum HDHP deductible is satisfied by the employee. After the statutory minimum HDHP deductible for the type of coverage elected by the employee (self-only or family) is satisfied, medical expenses could, for example, be reimbursed by the employer or by a post-deductible HRA or health flexible spending account ("FSA"), and the individual would remain an eligible individual. The Notice also addresses when the satisfaction of an "embedded individual deductible" for employees with family HDHP coverage will be permitted.

## **B. High Deductible Health Plans**

To qualify as a high deductible health plan, a health plan must have annual deductibles and annual maximum out-of-pocket expenses that comply with the statutory requirements. For 2008, the annual maximum out-of-pocket expense limit for self-only HDHP coverage is \$5,600, and the annual maximum out-of-pocket expense limit for family HDHP coverage is \$11,200. For 2009, those limits increase to \$5,800 and \$11,600 respectively. The maximum out-of-pocket expenses include the annual deductible, co-payments, and coinsurance.

Coverage under an HDHP must be meaningful, i.e., significant medical benefits must be available to individuals covered under the HDHP. An HDHP, the Notice states, may, however, include reasonable benefit restrictions such as limiting benefits for specific illnesses provided that significant other benefits remain available in addition to the benefits excluded. An HDHP may also include separate or higher deductibles for specific benefits. The Notice provides examples illustrating these rules.

In addition, the Notice addresses the allocation of covered expenses when an individual switches from family HDHP coverage to self-only HDHP coverage. Generally, a self-only HDHP may use any reasonable and consistent method to allocate the expenses incurred during the period of family HDHP coverage for purposes of satisfying the self-only HDHP deductible. For example, the plan could allocate to the self-only HDHP deductible the expenses incurred by the individual switching to self-only HDHP coverage or the plan could allocate expenses on a per-capita basis according to the number of persons covered by the family HDHP coverage. In allocating the expenses, the plan must comply with the COBRA continuation coverage regulations.

The Notice also clarifies that for purposes of determining whether the HDHP deductible has been satisfied, only medical expenses described in IRC § 213(d) and covered by the HDHP count toward satisfaction of the HDHP deduction. Medical expenses described in IRC § 213(d) but not covered by the HDHP would not count toward satisfaction of the HDHP deductible. For

example, an individual's HDHP does not include coverage for dental expenses. That individual incurs \$1,500 of dental expenses. Those dental expenses, although medical expenses described in IRC § 213(d), do not count toward satisfaction of the HDHP deductible because they are not expenses covered by the HDHP.

### **C. Contributions**

Individuals and/or employers may make contributions to an HSA up to a statutory amount which varies depending on the type of HDHP coverage the individual has. An individual who is an eligible individual for part of a year may contribute to the HSA with respect to the months the individual was an eligible individual. In addition, the TRHCA increased the amount that could be contributed if the individual was covered by a HDHP at the end of the year (rules pertaining to this expansion were discussed earlier in this memo). An eligible individual who has attained age 55 before the end of the taxable year is permitted to make an additional "catch-up contribution" to his or her own HSA.

Married couples with family HDHP coverage are treated as having only one family coverage and as such, may contribute the maximum annual HSA contribution limit for family HDHP coverage. If both spouses are eligible individuals, they may divide the contribution equally between them or agree on a different division. If eligible, both spouses may make a catch-up contribution without exceeding the family HDHP coverage contribution limit. The Notice clarifies that a catch-up contribution may only be made to the eligible individual's own HSA; that is, a spouse cannot make a catch-up contribution to his or her spouse's HSA.

HSA contributions may be made by the eligible individual, or the employer on behalf of the eligible employee, on or before the deadline (without extensions) for filing the individual's prior year's tax return. For example, an eligible individual may make an HSA contribution on April 15, 2009 for the 2008 year. This same rule applies to an employer making a contribution on behalf of an employee.

In addition to illustrating and clarifying the above rules, the Notice addresses specifically what corrections are available to an employer who makes an HSA contribution in error.

- An employer that contributes to an account of an employee who was never an eligible individual (and therefore, not eligible for an HSA contribution) may correct the error by requesting that the financial institution holding the HSA return the amounts to the employer. This must be done before the end of the taxable year or otherwise the contribution must be included in the employee's gross income and reported on the employee's Form W-2.
- If an employer contributes in error amounts to an employee's HSA account that exceed the maximum annual HSA contribution limit, the employer may request that the financial institution holding the HSA return the excess amounts to the employer. As with the previous example, this must be done before the end of the taxable year or otherwise the contribution must be included in the employee's gross income and reported on the employee's Form W-2. If the mistaken

contribution is not in excess of the maximum HSA contribution limit, the employer may not recoup the mistaken contribution from the employee's HSA.

- If an employer makes an HSA contribution to an employee's account after the employee ceases to be an eligible individual, the employer cannot recoup the amount that the employer mistakenly contributed.

Finally, the Notice also clarifies that employer contributions to an HSA of an employee's spouse (who is not an employee of the employer) are not excludible from the employee's gross income under IRC § 106, and accordingly, would be included in the employee's gross income and reported on the employee's Form W-2.

#### **D. Distributions**

An individual may receive a distribution from his or her HSA tax-free at any time to pay or reimburse qualified medical expenses of the individual (HSA account beneficiary) and his or her spouse and dependents. Any amount that an individual receives from his or her HSA that is not used to pay or reimburse qualified medical expenses would be included in the individual's gross income and may be subject to a 10% additional tax unless an exception applies.

Qualified medical expenses are amounts paid by the individual for medical care, as defined in IRC § 213(d), for the individual and his or her spouse and dependents. Health insurance premiums are not considered qualified medical expenses for purposes of distributions from the HSA with four exceptions. Premiums paid in the following circumstances are considered qualified medical expenses and reimbursable from an HSA—(i) premiums paid during a period of COBRA continuation coverage, (ii) premiums for qualified long-term care insurance, (iii) premiums paid during a period when the individual is unemployed and receiving Federal or state unemployment compensation, and (iv) premiums paid by an HSA account owner aged 65 or older.

The Notice generally illustrates the above rules. The Notice states that an HSA may be administered through a debit card provided the funds in the HSA are readily accessible in other ways, such as through on-line transfers. In addition, an HSA account beneficiary may designate another individual (or individuals) to withdraw funds from the HSA. Finally, the Notice confirms that qualified medical expenses include the IRC § 213(d) medical expenses incurred by an HSA account beneficiary's child who is claimed as a dependent by the account beneficiary's former spouse.

#### **E. Prohibited Transactions**

A prohibited transaction under IRC § 4975 is the impermissible sale, exchange, lease, loan, or use of plan assets between a plan and a disqualified person. If an HSA engages in a prohibited transaction, the HSA would cease to be an HSA and the funds in the HSA would be deemed to be distributed to the account beneficiary at the time of the prohibited transaction. The distribution would be included in the account beneficiary's gross income and subject to an additional 10% tax attributable to HSA distributions that are not used for qualified medical

expenses. If an employer sponsoring an HSA account engages in a prohibited transaction with the HSA, the employer is liable for any penalties and excise taxes assessed under IRC § 4975, with respect to the prohibited transaction.

The Notice discusses several types of transactions most common to HSAs that may be considered prohibited transactions. For example, if an HSA account beneficiary borrows funds from his or her HSA, the HSA will have engaged in a prohibited transaction. A prohibited transaction includes a direct or indirect extension of credit between the HSA and the account beneficiary. This type of prohibited transaction frequently arises in the context of an employer wishing to assist a seriously ill employee with medical expenses where the employee's HSA account may be exhausted and the employer instructs the HSA trustee to pay any expenses presented to the trustee by extending credit to the HSA, and the employer promises to make payment in the future to cover the expenses. This type of situation would be a prohibited transaction for the HSA, and would subject the HSA to the tax consequences described above. However, the Notice states that a separate line of credit by the HSA trustee to HSA owner, which is not secured by the HSA, is not considered a prohibited transaction. With this type of line of credit, payment of medical expenses in excess of the amount in the HSA can be made and a tax-free distribution can be made later in the year which would repay the loan. However that loan could not use the HSA as collateral since the Notice clarifies that when an account owner pledges his or her HSA as security for a loan, the account owner has engaged in a prohibited transaction with the HSA.

#### **F. Establishing an HRA**

As described above, an HSA is a trust established for the purpose of paying qualified medical expenses of the account beneficiary incurred after the trust has been established. Trusts are created under state law, and therefore, state law will determine the date that the trust is established. For example, most state trust laws provide that a trust is not created or established until the trust is actually funded, i.e., there must be assets in the trust for the trust to be created. An HSA may be funded with cash contributions or with rollover contributions. Some states may require an account beneficiary's signature in order to establish an HSA. For purposes of paying benefits from the HSA, the HSA is not considered established until the eligible individual is covered by a HDHP. Note, however, that if the eligible individual is covered by an HDHP before the HSA is funded (holds assets), the HSA will not be considered established until it satisfies the requirements of state law (typically, that the HSA be funded). These rules are important especially if an employer is establishing and funding HSAs for its employees.

The Notice reiterates these rules and provides clarity regarding the date of establishment of the HSA in circumstances where funds are rolled over from an existing HSA to a new HSA and where an account beneficiary establishes another HSA. Specifically, when an HSA is funded with a rollover from another HSA or an Archer MSA, the new HSA will be treated as established as of the date that the prior account was established. This rule does not apply to rollovers from health FSAs, HRAs, IRAs, or Roth IRAs. When an account beneficiary with a previously established HSA establishes a new HSA, the establishment date of the new HSA will depend on the balance in the pre-existing HSA during the preceding 18-month period. If at any time during the 18-month period ending on the date the new HSA is opened the pre-existing

HSA had a balance greater than zero, the new HSA will be deemed to have been established on the same date as the pre-existing HSA.

**G. Administration**

HSA administration lies primarily with the trustee of the HSA, and the trustee usually receives administration and maintenance fees. The Notice clarifies that such fees that are withdrawn from the HSA should be reflected by the trustee in box 5 on Form 5498-SA in the fair market value of the HSA at the end of the taxable year, i.e., the fair market value should be reduced by the fees withdrawn by the trustee from the HSA. Administrative and maintenance fees are not to be reported as distributions from the HSA.

\* \* \*

Authors: Jenifer Cromwell, Heather Meade, and William Sweetnam

If you have any questions, please contact your regular Groom contact or any of the Health and Welfare practice group attorneys listed below:

Jon W. Breyfogle	jwb@groom.com	(202) 861-6641
Gina M. Boscarino	gmb@groom.com	(202) 861-6645
Jenifer A. Cromwell	jac@groom.com	(202) 861-6329
Thomas F. Fitzgerald	tff@groom.com	(202) 861-6621
Debbie G. Leung	dgl@groom.com	(202) 861-2601
Christine L. Keller	clk@groom.com	(202) 861-9371
Heather E. Meade	hem@groom.com	(202) 861-0179
William F. Sweetnam	wfs@groom.com	(202) 861-5427
Christy A. Tinnes	cat@groom.com	(202) 861-6603
Donald G. Willis	dgw@groom.com	(202) 861-6332
Brigen L. Winters	blw@groom.com	(202) 861-6618