



## HSA Guidance on Rollovers and Eligibility

Participants in a general-purpose Health Flexible Spending Account (Health FSA) or Health Reimbursement Arrangement (HRA) want to set up and contribute to a Health Savings Account (HSA). How do they rid themselves of the non-HSA compatible coverage and begin to contribute to an HSA?

Legislation was first enacted in 2006 to allow participants to roll over contributions from their Health FSA or an HRA into an HSA (see article: [HSAs Slim Down for the New Year](#)). These one-time rollover amounts are called Qualified HSA Distributions and carry a plethora of rules and procedures. On February 15, 2007, the IRS expounded on the intricacies of when and how these rollovers could occur and when an employee is eligible to set up an HSA.

This latest guidance is offered through [IRS Notice 2007-22](#).

### Specific Rules

- 1 The employer must amend the Health FSA plan or the HRA plan by the last day of the plan year to allow for qualified HSA distributions from a Health FSA or an HRA to an HSA.
- 2 Only one transfer per plan allowed for each participant. For example, a participant could make one rollover of funds from their Health FSA and one rollover from their HRA, but not two separate rollovers from their Health FSA.
- 3 The participant must have qualifying high-deductible health plan (HDHP) coverage as of the first day of the month during which a rollover occurs.
- 4 The participant must elect before the end of the plan year to have the employer initiate the rollover on their behalf.
- 5 The Health FSA or the HRA cannot make any reimbursements to the participant after the last day of the plan year.
- 6 The employer must make a direct “trustee to trustee” transfer of the funds directly to the HSA custodian by the 15th day of the third month following the end of the plan year, and the participant must be HSA-eligible.
- 7 The distribution from the Health FSA or the HRA cannot exceed the lesser of the balance of the Health FSA or HRA on a) September 21, 2006, or b) the date of the distribution.
- 8 After the distribution, there must be a zero balance in the Health FSA or HRA. The participant may not be covered by a non-HSA compatible health plan after the distribution. The employer could accomplish this by converting the Health FSA or HRA to an HSA-compatible flexible benefit plan for all participants.

### Subtle Details

The IRS examples that illustrate these procedures define the ins and outs of this guidance, and deal mostly with the requirements of rule number eight.

- Employers must adopt the 2-1/2 month extended period of coverage amendment for their Health FSA plan.
- On the last day of the plan year, the employee must have a zero balance in their Health FSA or HRA.
  - “Balance” is determined on a cash basis. That means that all funds must have been paid out their account or rolled to an HSA. This would not take

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into consideration claims that the participant might have incurred, but had not submitted to the plan administrator. “Balance” does not count claims submitted to the plan administrator that are not paid by the end of the plan year. These type of claims – submitted but not reimbursed or incurred but not submitted – may not be paid after the end of the plan year from the Health FSA or HRA.

- Of course, the “September 21, 2006” rule must be kept in mind. The amount rolled to an HSA is the lesser of the account balance on September 21, 2006 or the account balance on the date of the distribution. If the participant’s balance at the end of any plan year is greater than their balance on September 21, 2006, the account balance could not be brought to zero with a rollover, and they would not be eligible to immediately set up an HSA.
- Participants cannot roll over funds in the middle of the Health FSA or HRA plan year because their non-HSA compatible coverage continues until the end of that plan year. Again, they would not be eligible to immediately set up an HSA.

### **Penalties for Non-Compliance**

What happens when employers or participants don’t follow all the rules? The entire rollover amount is included in the participant’s taxable income – plus an additional 10 percent tax is due. This is a high price to pay.

Another directive to keep in mind: Participants must maintain a qualifying HDHP for a designated period of time following the rollover. The participant must maintain an HDHP for a “testing period” that starts with the date of the distribution and ends on the last day of the 12th month following the distribution date. Otherwise, the amount of the Qualified HSA Distribution will be included in the gross income of the participant when they become ineligible to participate in an HSA. A 10 percent additional tax will also apply to the distribution amount.

### **All These Rules Make My Head Hurt**

By now, you might be saying, “Why bother?” And the truth is, the employer does not have to allow rollovers into a participant’s HSA. (Remember, rule number one says the employer must actively amend their FSA and/or HRA plan to allow for rollover to an HSA.)

Participants who elect HDHP coverage may set up their HSA when the Health FSA or HRA plan year is over and their balance in the account is zero. This time frame would also include the 2-1/2 month extended period of coverage for the Health FSA, if applicable. And waiting until after the beginning of a taxable year to establish an HSA does not forfeit their right to maximize contributions to their HSA plan. Due to previous legislation, they may contribute the entire annual limit to an HSA even if their HSA was established after January 1.

So, your client thinks they want to initiate Qualified HSA Distributions? Advise them to seek the help of an attorney to make sure they are accomplishing their goals while complying with these complicated regulations. ■

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