

The Glynn Group, Ltd.

June 29, 2007

Issue # 254

New HSA Contribution and Rollover Rules.

As you recall, the Tax Relief and Health Care Act of 2006 (the Act) was signed into law last December. The legislation provides liberalized rules for health savings account (HSA) contributions. While the new rules are advertised as being very taxpayer-friendly, they also include unadvertised complications and nasty traps for the unwary.

Contributions No Longer Limited to Health Plan Deductible

Probably, the most important change is that for tax years beginning after 2006, there's no longer any direct linkage between the annual HSA contribution limit and the annual deductible for the taxpayer's underlying high-deductible health plan (HDHP) coverage. In contrast, for pre-2007 tax years HSA contributions were limited to no more than the amount of the HDHP deductible.

For instance, say you had family HDHP coverage with a \$2,500 deductible for all of 2006. The maximum HSA contribution for that year was limited to the lower of: (1) the \$2,500 HDHP deductible or (2) the \$5,450 dollar cap for individuals with 2006 family coverage. As you can see, the two-pronged limitation rule worked against folks with lower HDHP deductibles.

For 2007, however, the HSA contribution cap is either: (1) \$2,850 for an eligible individual with self-only HDHP coverage (regardless of the plan's deductible) or (2) \$5,650 for an eligible individual with family HDHP coverage (regardless of the plan's deductible). [See IRC Sec. 223(b)(2).] The inflation adjusted amounts for 2008 are \$2,900 and \$5,800, respectively. The new one-pronged limitation rule is both helpful and simple. We like that!

Warning: For a health plan to be an HDHP for 2007 or 2008, the plan must have a deductible of at least: (1) \$1,100 for self-only coverage or (2) \$2,200 for family coverage. In addition, the plan's 2007 out-of-pocket maximum cannot exceed: (1) \$5,500 for self-only coverage or (2) \$11,000 for family coverage. (See Rev. Proc. 2006-53.) It's 2008 out of pocket can't exceed \$5,600 for self only coverage or \$11,200 for family coverage. (See Rev. Proc. 2007-36.) These figures are adjusted for inflation annually.

FSA Grace Period No Longer Makes Employees Ineligible for HSA Contributions

Say an employee is covered by a health care flexible spending account (FSA) plan that doesn't have a high deductible (most either have no deductible or a very low deductible). Since an FSA without a high deductible is considered to be a health plan that is not an HDHP, coverage under such an FSA generally renders the employee ineligible for HSA contributions. [See IRC Sec. 223(c)(1)(A) and Rev. Rul. 2004-45 for details and a few exceptions.]

The Act provides an important exception to the preceding general rule. If the employee is considered to be covered under the FSA solely due to the existence of the plan's post-year-end grace...

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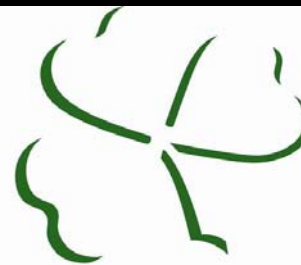
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period (which can be up to 2½ months after year-end pursuant to Notice 2005-42), the post-year-end grace period coverage is ignored for purposes of determining eligibility for HSA contributions. To qualify for this favorable exception the following requirements must be met: (1) the year-end balance in the employee's FSA must be either zero or entirely rolled over into the employee's HSA under the FSA-to-HSA rollover privilege explained later in this release, and (2) the employee must cease participating in the FSA after year-end. If the first requirement is not met, the employee is ineligible for HSA contributions until the first day of the month following the month during which the grace period expires (which generally translates to April 1).

Note: This favorable exception applies to tax years beginning after 2006. [See IRC Sec. 223(c)(1)(B)(iii).] For pre-2007 years, employees were generally ineligible to make HSA contributions until the FSA grace period had expired.

Exception to Comparability Rules for Employer HSA Contributions

For tax years beginning in 2007 and beyond, the Act provides a favorable exception to the general HSA comparable contribution requirements. The exception allows employers to make larger HSA contributions for non-highly compensated employees (NHCEs) than for highly compensated employees (HCEs) without being hit with the punitive 35% penalty tax that would otherwise apply. [See IRC Sec. 4980G(d).] Note, however, that the comparability rules are unchanged for employer contributions to HSAs of NHCEs. In other words, comparable contributions must still be made for NHCEs under the comparability rules found in Regs. 54.4980G-1 through -5. See NTA-613 (dated 9/26/06) for a summary of the comparability rules.

Note: For this purpose, an HCE is an employee who: (1) was a more-than-5% owner at any time during the year or the preceding year or (2) had compensation exceeding \$100,000 for the preceding year and, if elected by the employer, was in the top 20% of employees ranked by compensation.

HSA Contribution Eligibility for Entire Year Can Be Determined at Year-end

Say an individual has HDHP coverage for only part of the year. For pre-2007 years, the maximum HSA contribution was limited to $\frac{1}{12}$ of the annual maximum amount times the number of months of HDHP coverage. Similarly, say an individual has HDHP coverage for part or all of the year, but is also covered by a health plan that's not an HDHP for part of the year. For pre-2007 years, the maximum HSA contribution was limited to $\frac{1}{12}$ of the annual maximum amount times the number of months during which there was HDHP coverage without any prohibited non-HDHP coverage. In other words, an individual who was ineligible for HSA contributions for part of a pre-2007 year could only make a partial contribution for that year equal to $\frac{1}{12}$ of the annual maximum amount times the number of months of eligibility.

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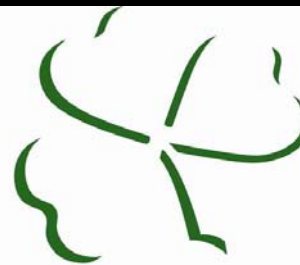
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This month-by-month contribution limitation rule still generally applies, but the Act provides an important exception. For tax years beginning after 2006, HSA contributions can be based on the individual's eligibility status during the last month of the year. So, a calendar-year individual who has HDHP coverage during December 2007 and no coverage under a health plan that's not an HDHP during that month can make an HSA contribution for 2007 of up to: (1) \$2,850 for self-only coverage or (2) \$5,650 for family coverage. [See IRC Sec. 223(b)(8)(A).]

So far, so good. But watch out for a trap for the unwary. If an individual takes advantage of the preceding rule to make a larger HSA contribution and then becomes ineligible for HSA contributions during the *testing period*, an unfavorable recapture rule kicks in. The testing period begins with the last month of the tax year for which the larger contribution was made and ends on the last day of the 12th month following that month. The recapture amount equals the actual HSA contribution minus the maximum contribution that would have been allowed under the general month-by-month limitation rule. Plus the recapture amount gets hit with a 10% penalty tax. Ouch! More specifically, the recapture amount must be included in income, subject to the 10% penalty tax, for the tax year that includes the first day within the testing period during which the individual becomes ineligible for HSA contributions. [See IRC Sec. 223(b)(8)(B).] Unfortunately, this is yet another illustration of our beloved Congress granting a well-advertised tax break with one hand while sneaking it away with the other hand.

There's no requirement to withdraw the recapture amount from the HSA. This is good in that it can be left in the HSA where it can grow federal-income-tax-free and eventually be withdrawn federal-income-tax-free to pay for eligible medical expenses. However, according to Rev. Proc. 2007-22, if the eventual distribution is not used to pay qualified medical expenses, it is taxable again and is subject to the 10% penalty applicable to HSA distributions not used to pay qualified medical expenses. This is terrible!

Limited HSA Rollover Privilege for Certain Health Care FSA and HRA Balances

For distributions on or after 12/20/06, the Act allows distributions from employer-provided health care flexible spending accounts (FSAs) or health reimbursement arrangements (HRAs) to be rolled over tax-free into HSAs via direct transfers between the accounts. [See IRC Sec. Sec. 106(e).] This new rollover privilege is supposed to further promote the HSA cause. Good! As you will see, however, our beloved Congress felt compelled to add a bunch of complicated qualification rules plus a nasty recapture trap. Not good!

Requirements and Limitations. Unless Congress extends it, the FSA/HRA-to-HSA rollover contribution privilege will expire after 2011. Also, the amount rolled over cannot exceed the lesser of: (1) the balance in the employee's health care FSA or HRA as of 9/21/06 or (2) the balance in the health care FSA or HRA as of the distribution date.

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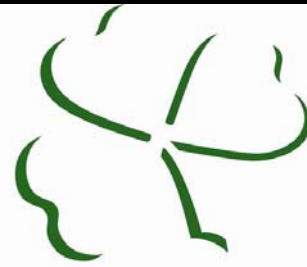
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So, the rollover option is only available to an employee who had a balance as of 9/21/06. Everybody else is out of luck. Per Notice 2007-22, FSA and HRA balances are to be determined using cash-basis accounting (i.e., any pending but unpaid claims are not taken into account).

Only one rollover is allowed for each FSA or HRA owned by the employee. Done properly, the amount rolled over into the HSA is excluded from the employee's income for both FIT and federal employment tax purposes. So, such rollovers can be totally federal-tax-free maneuvers if all the applicable requirements are met. Rollover contributions are nondeductible, and they don't affect the employee's or the employer's ability to make regular deductible contributions to the employee's HSA.

Under a comparability rule, if an employer allows any employee to make an FSA/HRA-to-HSA rollover contribution, all employees who are covered under the employer's HDHP must be allowed to make such rollover contributions. A punitive 35% excise tax applies if the comparability rule is violated. [See IRC Sec. 106(e)(5) (B).]

There's more. According to IRS Notice 2007-22, all of the following requirements must be met to make a tax-free HSA rollover contribution from a health care FSA with a grace period or from an HRA.

1. By the last day of the plan year, the FSA or HRA plan document must be amended to permit such rollovers into employee HSAs.
2. By the last day of the plan year, the employee must elect to make the rollover.
3. The employee's coverage under the FSA or HRA plan generally must be terminated as of the plan's year-end (except for FSA coverage that is due solely to the plan's grace period). Why? Because, as discussed earlier, coverage under a health care FSA or HRA is generally considered to be coverage under a health plan that's not an HDHP, and such coverage generally makes the employee ineligible for HSA contributions.
4. The FSA or HRA funds must be rolled over by the employer into the employee's HSA within 2½ months after the FSA or HRA plan's year-end. No FSA or HRA reimbursements can be made to the employee after the plan's year-end.
5. The employee must be eligible to make HSA contributions as of the first day of the month during which the rollover contribution occurs. In other words the employee must have HDHP coverage and meet the other HSA contribution eligibility rules as of the first day of that month.

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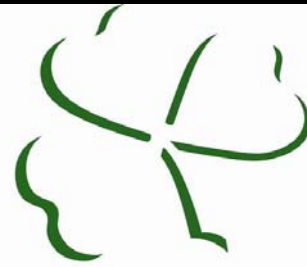
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6. After the rollover contribution, the employee's health care FSA or HRA balance must be zero.

If any of these requirements are not met, the amount of the rollover contribution must be included in the employee's gross income and be hit with the 10% penalty tax. There's no requirement to withdraw the recapture amount from the HSA. Once again, this is good in that it can be left in the HSA where it can grow federal-income-tax-free and eventually be withdrawn federal-income-tax-free to pay for eligible medical expenses. But, it is terrible if the eventual distribution is not used to pay eligible medical expenses making it taxable again and subject to another 10% penalty.

Note: Although they are of only historical interest at this point, special transitional rules were provided for rollovers of 12/31/06 health care FSA and HRA balances. Such rollovers had to be completed by 3/15/07.

Recapture Rule. If an employee makes a FSA/HRA rollover contribution and becomes ineligible for HSA contributions during the *testing period* (beginning the month of the rollover contribution and ending on the last day of the 12th month following that month), the nasty recapture rule rears its ugly head once again. More specifically, the entire rollover contribution must be included in income, subject to the 10% penalty tax, for the tax year that includes the first day within the testing period during which the employee becomes ineligible for HSA contributions.

Again, there's no requirement to withdraw the recapture amount from the HSA. This is good if eventually withdrawn to pay for eligible medical expenses (which will be federal-income-tax-free), but terrible if not (because it will be taxable again and subject to another 10% penalty).

Limited HSA Rollover Privilege for Certain IRA Distributions

For tax years beginning in 2007 and beyond, the Act allows eligible individuals to make a one-time, tax-free rollover of otherwise taxable amounts from a traditional IRA or a Roth IRA into an HSA via a direct trustee-to-trustee-transfer between the accounts. This rollover privilege is unavailable for active SEP IRAs or SIMPLE IRAs. [See IRC Sec. 408(d)(9).]

Requirements and Limitations. The IRA-to-HSA rollover contribution cannot exceed the individual's maximum HSA contribution limit for the rollover year, based on whether the individual has self-only or family coverage under an HDHP at the time of the rollover. For 2007, therefore, the maximum amount that can be rolled over is either: (1) \$2,850 for self-only coverage or (2) \$5,650 for family coverage. The individual's deductible HSA contribution maximum for the year is reduced by the rollover contribution, and no deduction is allowed for the rollover contribution.

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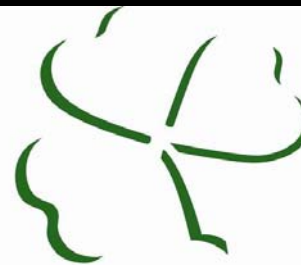
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In general, only one IRA-to-HSA rollover contribution can be made during an individual's lifetime. However, if a rollover is made during a month in which the individual has self-only coverage as of the first day of that month, an additional rollover can be made during a subsequent month within that same tax year (and only in that same year) in which the individual has family coverage. The combined amount of the two rollover contributions cannot exceed the HSA contribution maximum for family coverage.

Amounts rolled over into an HSA under this provision are deemed to come from the individual's taxable traditional IRA balances or taxable Roth IRA balances. Nontaxable amounts are left behind in the traditional or Roth IRA(s).

Observation: In general, rolling over funds from a Roth IRA makes little sense because an individual can receive qualified Roth IRA distributions federal-income-tax-free anyway. In contrast, rolling over funds from a traditional IRA may make more sense because the rolled-over amount is effectively converted into money that can be withdrawn federal-income-tax-free to pay for eligible medical expenses.

Recapture Rule. At this point, you will not be surprised to learn that a recapture rule also applies when an individual makes an IRA-to-HSA rollover contribution and becomes ineligible for HSA contributions during the *testing period*. Once again, the testing period begins with the month of the rollover contribution and ends on the last day of the 12th month following that month. If the recapture rule applies, the entire rollover contribution amount must be included in gross income and hit with a 10% penalty tax. More specifically, the recapture amount is included in income, subject to the 10% penalty tax, for the tax year that includes the first day within the testing period during which the individual becomes ineligible for HSA contributions.

Again, there's no requirement to withdraw the recapture amount from the HSA. This is good if eventually withdrawn to pay for eligible medical expenses (which will be federal-income-tax-free), but terrible if not (because it will be taxable again and subject to another 10% penalty).

Bottom Line: The dreaded recapture rule can again come into play as late as the year after an IRA-to-HSA rollover contribution is made. Since most folks can't see accurately that far into the future, we sure wouldn't argue with anyone who thinks the IRA-to-HSA rollover contribution deal is rather unappealing.

If you have questions on this article, please contact [The Glynn Group, Ltd.](#)

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