GROOM LAW GROUP

MEMORANDUM

February 25, 2007

Treasury and IRS Issue Guidance on HRA & Health FSA Transfers to HSAs

On February 15, 2007, the IRS issued much-anticipated guidance, Notice 2007-22 ("Notice"), describing the steps that an employer and employee must follow to transfer amounts from a health flexible spending arrangement ("FSA") or health reimbursement arrangement ("HRA") to a health savings account ("HSA") on a tax-free basis. Although the statute[1] that created the transfer rights is relatively straightforward, the Notice imposes detailed timing and account balance requirements that must be followed to avoid adverse tax consequences for the HSA account owner.

Below, we provide a summary of the statute and Notice (including a few helpful clarifications that the Notice contains), together with a checklist that can be used to determine whether the requirements are satisfied. It should be noted that employers must report transfers as rollover contributions to the HSA trustee/custodian, who, in turn, is required to report this information to the IRS on Form 5498-SA. Accordingly, this is an area that the IRS has some ability to monitor. Plan sponsors should therefore exercise caution in determining that all requirements described in the Notice have been satisfied before making the transfer.

Background on HRA/FSA Rollovers and the New Law

Under prior law, no transfer from an FSA or an HRA to any other type of account, including an HSA, was permitted. Under the new law (Code § 106(e)), an employer may amend the FSA/HRA plan to allow an employee to make a one-time transfer of the balance remaining in his or her FSA or HRA as of September 21, 2006 (or, if less, the balance on the date of the transfer) to an HSA.[2] A transfer must be made before January 1, 2012. Employers allowing any employee to make the one-time transfer from an FSA or HRA must make it available to all eligible individuals covered by an HDHP of the employer.

An FSA/HRA transfer made pursuant to Code § 106(e) is not taken into account for purposes of determining the HSA annual contribution limitation (i.e., $2,850 for self-only coverage and $5,650 for family coverage for 2007), and is excludable from income and wages for FICA tax purposes. In addition, a transfer is not deductible as an HSA contribution on an individual's Form 1040. An important condition for making a tax-free transfer is that an

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[1] Section 302(a) of The Tax Relief and Health Care Act of 2006 ("Act") amended Internal Revenue Code section 106 by creating a new subsection (e), which allows for a tax-free transfer from an FSA or HRA to an HSA.

[2] The transfer from an FSA or HRA to an HSA is referred to as a "Qualified HSA Distribution" in Code section 106(e).

individual remain an "eligible individual" (i.e., the individual must maintain high deductible health plan ("HDHP") coverage and no other non-HDHP coverage) for a period of 13 consecutive months, beginning with the month the transfer is made. If the individual loses eligible individual status, (e.g., by dropping HDHP coverage during the 13-month period or by having other medical coverage below the deductible), transferred amounts are includible in the HSA account-owner's income and subject to a 10% additional tax.

New Requirements Under Notice 2007-22

In determining what requirements an employer must satisfy to comply with new Code section 106(e), the IRS has taken a surprisingly narrow reading of the statute that results in several complex and restrictive rules. For example, the IRS has determined that it is generally not possible for an employee to do a tax-free transfer during the year, but rather, that the transfer must take place during the 2-1/2 month period following the close of the year and the employer must "freeze" the balance that is left in the account as of the last day of the plan year. For an FSA, this means that the employer must adopt a grace period extension in order to make a tax-free transfer. The IRS further determined that any transfer must result in a zero balance in the FSA or HRA in order to be tax-free to the HSA account owner. This means that any individual with a balance in his or her FSA or HRA account on the date of the transfer that exceeds the balance on September 21, 2006 cannot do a tax-free transfer. In addition, the IRS determined that an employer may not unilaterally decide to do a tax-free transfer. Rather, employees must "elect" to do the transfer. This creates an additional administrative burden for the employer to comply with. These and other steps that the employer and employee must follow in order to ensure that a transfer is tax-free are summarized in the attached checklist.

If the steps identified in the Notice are not followed, the Notice states that the transfer will be includable in the employee's income and subject to a 10% additional tax. The circumstances that may cause an HSA transfer to be taxable to the HSA account owner and subject to an additional 10% tax include the following:

- Failure to transfer entire balance from FSA or HRA.
- Transfer before or after 2-1/2 month period following end of FSA or HRA plan year.
- A transfer which occurs during a month in which the individual was not covered by HDHP coverage as of the first of the month.
- Disqualifying coverage under HRA or FSA after the transfer, which includes reimbursing expenses out of the account after the end of the plan year.
- Failure to remain an eligible individual during the 13-month testing period following the transfer.

Clarifications in Notice 2007-22

The good news with respect to the Notice is that it includes the following clarifications, which are generally helpful for employers and HSA account owners:

- **Grace Period/Zero Balance Rule**

A participant in an FSA with a grace period who has a zero balance on the last day of the plan year may be treated as an eligible individual for purposes of making HSA contributions for the entire following year.

> *Observation:* This rule appears in Section 302(b) of the statute, and the IRS plainly interprets the rule and does not add any new conditions, which is helpful. The IRS also adds language relating to an HRA with a zero balance, which arguably is not needed because it simply reiterates the IRS position described in Rev. Rul. 2004-45 regarding when an HSA account owner could also participate in an HRA.

- **No Excess Contribution**

Failing to remain an eligible individual during the testing period does not require the withdrawal of the transferred amount, and the amount is not an excess contribution.

> *Observation:* This clarification is helpful because it means that even if the HSA account owner fails the testing period requirement and has to pay income tax and a 10% additional tax on the transferred amount, such individual can leave the transferred amount in the HSA without paying an excise tax of 6% each year under Code section 4973.

- **Cash Basis Determination of Balance**

The balance in the health FSA or HRA as of any date is determined on a "cash basis." The Notice explains that this means that pending and unsubmitted claims are not taken into account, regardless of when the expense was incurred.

> *Observation:* This clarification is consistent with the legislative history of the Act, which indicates that the balance in the health FSA or HRA as of any date is determined on a cash basis and that expenses incurred that have not been reimbursed as of the date the determination is made are not taken into account.

- **No Employer Testing Period Reporting Required**

Employers are not responsible for reporting whether an employee who makes an FSA or HRA transfer remains an eligible individual during the testing period. In addition, the Notice states that it is not required that an employee be an eligible individual with HDHP coverage in order to have a transfer made on the employee's behalf. However, as a practical matter, the employer should verify eligible individual status before making the transfer, because otherwise the transfer will be taxable to the employee and subject to a 10% additional tax.

> *Observation:* This clarification is helpful because it suggests that employers do not have any obligation to monitor employee's coverage during the testing period following a transfer. However, it appears that if the requirements of the Notice are not satisfied at the time of transfer, the employer may be required to report the transferred amount as wages

on the employee's Form W-2. It would be helpful if the IRS clarified this point, however.[3]

- **HSA Establishment**

The determination of when an HSA is "established" is made under state trust law and most state trust laws require that a trust must be funded to be established.

Observation: This clarification is helpful to the extent that it confirms that federal law will not impact the determination of when an HSA is established. However, the statement regarding the requirements of "most state trust laws" is also somewhat misleading because an HSA may also be established as a custodial account, and different state laws could apply on that basis.

- **Comparable Contribution Rules**

The Notice states that in order to comply with the comparability rules in Code § 4980G, the transfer must be offered to all eligible individuals with HDHP coverage offered by the employer. This confirms that an employer would not be required to offer a transfer to any employees who have HDHP coverage that the employer does not sponsor.

Observation: This position is consistent with the statute and helpful. The statement appears to override the comparable contribution rule under Treas. Reg. § 54.4980G-3, Q&A-7(b), which states that where an employer contributes to the HSA of any employee who is covered by an HDHP that is not sponsored by the employer, the employer must contribute to the HSAs of all employees who are covered by an HDHP that is not sponsored by the employer.

Effective Date of Notice 2007-22

The Notice states that the effective date of the transfer rules is on or after December 20, 2006 and before January 1, 2012, so presumably, the Notice is immediately effective. The Notice does include a transition period, which ends on March 15, 2007. However, the transition period rules are generally the same as those described above, except that adjustments have been made for end-of-year requirements that would have been impossible to satisfy for 2007 given that the guidance came out after December 31, 2006.

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[3] The legislation that created HSAs also amended the FUTA and income tax withholding sections of the Code (sections 3306 and 3401, respectively) to provide that FUTA and income tax withholding requirements do not apply to "any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(d)." This standard would not appear to apply because the FSA/HRA transfer would be made under Code § 106(e). Accordingly, it is not entirely clear what an employer's obligations are with respect to reporting transferred amounts as wages on the employee's W-2 if the requirements of the Notice are not satisfied.

HRA/FSA Compatible Coverage Rules

The rules described above presume that the FSA or HRA is a "general purpose" arrangement, which would be disqualifying coverage for an HSA-eligible individual. If the FSA or HRA arrangement is a limited purpose or other arrangement described in Rev. Rul. 2004-45, the transfer could be made at any time during the plan year, and need not result in a zero balance. Unfortunately, the Notice indicates that employer may not convert a general purpose HRA or FSA to an HSA-compatible arrangement only for HSA-eligible individuals who elect transfers. Rather, such arrangement would have to be converted for all employees.

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For more information on HSAs and the new guidance, please contact Christine Keller, Bill Sweetnam, Brigen Winters, Chris Condeluci or Heather Meade by calling (202) 857-0620.