

## HSA Rollover Guidance Helps Plan Sponsors Switch From HRAs to HSAs

New IRS guidance will be particularly helpful to employers who caught the leading edge of the consumer-driven health care (CDHC) wave and established CDHC plans that included health reimbursement arrangements (HRAs).

**NOTE:** HRAs are entirely employer-funded medical reimbursement arrangements. Under an HRA, the employer credits a specified amount to each employee's HRA balance each month or year. The HRA balance is available to pay qualifying medical expenses of the employee and his family. If an employee does not spend his entire balance, most HRAs allow the balance to roll over from year to year. Employees participating in HRAs frequently build up substantial balances.

When Congress authorized health savings accounts (HSAs) starting in 2004, many employers with these early CDHC plans wanted to change their plans to have HSAs take the place of HRAs. In most cases, however, participating in an HRA will make an employee ineligible for HSA contributions, so eliminating HRA participation would facilitate moving to HSAs. But many employers were reluctant to force forfeitures of unused HRA balances or, alternatively, to suspend HRA participation and carry the unused balances indefinitely. The ideal solution would be to transfer unused HRA balances into individuals' HSAs. Until December 2006, however, the laws governing HRAs and HSAs specifically prohibited such transfers.

The law has now changed. (See Willis *Employee Benefits Alert* #91, *Health Savings Account Legislation Makes HSAs More Flexible*, for information about changes made by the December 2006 legislation.) A one-time rollover of the balance in the individual's account as of the date of the distribution is now permitted; however, the rollover amount is limited by the balance in the account as of September 21, 2006. While this rollover is not as open-ended as employers would like, the rollover may still be a useful tool for plan sponsors contemplating changing from an HRA program to a high deductible health plan coupled with an HSA.

### Background

In December 2006, Congress authorized rollovers from HRAs into HSAs for a limited time (until January 1, 2012). The new legislation allows each HRA to make only one rollover distribution and limits the rollover amount to the September 21, 2006 HRA balance. Unfortunately, the new law provided few other details on the requirements for valid rollovers, and many employers decided to wait for IRS guidance before implementing a rollover program.

The new IRS guidance discussed in this *Alert* provides details that employers need to set up a process for individuals to roll over year-end HRA balances. In addition, the IRS guidance provides a small window (until March 15) under which

employers can allow rollovers of HRA balances that were unused at the end of 2006.

### What Does the New IRS Guidance Say?

The IRS guidance explains that a "qualified HSA distribution" is a direct rollover from a health Flexible Spending Account (health FSA) or an HRA to an individual's HSA, that meets certain conditions.

**NOTE:** While the IRS guidance discusses rollovers from both HRAs and health FSAs, rollovers from health FSAs will be beneficial only in limited situations. (See the last section in this *Alert* for additional information about rollovers from health FSAs.) Therefore, in this *Alert*, we focus on rollovers from HRAs to HSAs.

The following eight conditions must be met in order for a qualified HSA distribution from an HRA to occur so that an employee becomes an individual eligible for HSA contributions as of the first day of the next plan year:

1. By the last day of the current plan year, the employer must have amended the HRA plan document to allow a qualified HSA distribution;
2. A qualified HSA distribution must not have been made previously on behalf of the employee with respect to that particular HRA;
3. The employee must be an eligible individual (including having HDHP coverage in effect) as of the first day of the month during which the qualified HSA distribution takes place;
4. By the last day of the current plan year, the employee must have elected to have the employer make a qualified HSA distribution from the employee's HRA;
5. The HRA must not make any reimbursements to the employee after the last day of the current plan year;
6. The employer makes the qualified HSA distribution directly to the HSA trustee by the earlier of January 1, 2012 or the 15<sup>th</sup> day of the third month of the next plan year, but after the employee becomes an eligible individual who is entitled to receive HSA contributions;
7. The qualified HSA distribution does not exceed the lesser of the HRA balance on (a) September 21, 2006; or (b) the date of the distribution; and
8. Either—
  - i. there is a zero balance in the HRA after the qualified HSA distribution and the employee is no longer a participant in any plan that would make the employee ineligible for HSA contributions (e.g., a low-deductible health plan); or,

- ii. effective on or before the date of the first qualified HSA distribution, the HRA plan is converted to an HSA-compatible HRA for *all* HRA participants (e.g., by making HRA balances available only for vision and dental expenses).

NOTE: Because qualified HSA distributions are limited to a participant's balance as of September 21, 2006, these distributions are not available to any participant who was not a participant in the HRA on September 21, 2006 or who had a zero balance on that date.

### Transition Rule

There is transitional guidance that applies only to qualified HSA distributions of December 31, 2006 balances. Qualified HSA distributions of those 2006 balances must take place by March 15, 2007.

Under the transition rule, an employee with a balance in a general purpose HRA after December 31, 2006 is treated as an HSA eligible individual as of the first day of the first month in 2007 that the employee would meet all of the requirements to be an eligible individual if the HRA were not in effect. These requirements include having HDHP coverage in effect on the first day of the month. The transition rule requires that all eight of the requirements set out above are met, with the following exceptions:

- The HRA plan amendment allowing the qualified HSA distribution need only be completed by March 15, 2007;
- There is no requirement to freeze the year-end balance in the HRA;
- The employee must elect the qualified HSA distribution before March 15, 2007; and
- The actual transfer to the HSA must be completed by March 15, 2007.

### Balances Determined on Cash Basis

For all purposes, HRA balances are determined without taking into account any expenses that

may have been incurred or submitted but that have not actually been paid as of the relevant date. Pending claims, claims submitted, claims received, or claims under review that have not been paid as of the date are not taken into account for purposes of determining the HRA balance.

### **Comparability Requirement**

If a qualified HSA distribution is offered to any employee, the employer must offer a qualified HSA distribution to all eligible individuals covered under an HDHP of the employer.

### **Tax Impact**

A qualified HSA distribution is considered a rollover contribution and therefore does not reduce the annual contribution limit to an HSA. It also is not a contribution for which the employee can claim a deduction on his income tax return.

In order for the qualified HSA distribution to retain its tax advantages, the individual must remain an HSA eligible individual during a testing period which begins with the month in which the qualified HSA distribution is contributed to the HSA and ends on the last day of the twelfth month following such month. For example, if the qualified HSA distribution is rolled over in March, 2007, the testing period runs from March, 2007 through April, 2008. If the individual does not remain an eligible individual during this time, the entire rollover amount is included in the individual's taxable income and is subject to an additional ten percent tax. These tax consequences do not apply if the employee is not an eligible individual due to the employee's death or disability.

Even if an employee fails to remain an eligible individual, it does not mean that the qualified

HSA distribution is an excess contribution that must be withdrawn from the HSA. The rollover amount remains in the HSA and can grow on a tax-free basis. If, however, the rollover money is withdrawn for an expense that is not a qualifying medical expense, it is included in the accountholder's income again and subjected to the ten percent tax again because it was not used for a qualifying expense.

### **Rollovers from Health FSAs**

The same requirements and transition rules that apply to rollovers from HRAs also apply to rollovers made from general purpose health FSAs. If the general purpose health FSA has been amended to permit reimbursement of claims incurred during the 2 ½ month grace period after the end of the plan year, an otherwise eligible individual generally may not make an HSA contribution until the first of the month following the end of the grace period.

However, if the individual's entire account balance is rolled over to the HSA on a timely basis per this guidance (or if the account balance was zero as of the end of the plan year), the otherwise eligible individual may make a tax deductible contribution during the grace period. Since the disregarding of coverage only applies to the extension period, the ability to make a one-time rollover from a health FSA only pertains to those plans that include the 2 ½ month grace period. The deadline is March 15, 2007 for a rollover of the December 31, 2006 health FSA balance.

The guidance provided in IRS Notice 2007-22 covers only some of the changes enacted with the *Tax Relief and Health Care Protection Act of 2006*. We expect the IRS will release additional guidance relating to the other changes.

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