



# SPECIAL Alert

## In This Issue

*In this third issue of the McGraw Wentworth Special Alert for 2007, we will discuss new guidance recently issued to address the administrative requirements for rollovers from medical Flexible Spending Accounts (FSAs) and Health Reimbursement Arrangements (HRAs).*

*The applicability of these rollovers is very limited and the administrative requirements are fairly complex. If your organization plans to offer employees the ability to rollover funds from either an FSA or an HRA, make sure your plan meets all the administrative requirements.*

*We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGraw Wentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “More Guidance on FSA and HRA Rollovers”

The IRS recently released Notice 2007-22 to provide additional guidance on Health Savings Accounts (HSAs) rollovers from Health Reimbursement Arrangements (HRAs) and Flexible Spending Accounts (FSAs). Rollovers from HRAs and FSAs are allowed under the Tax Relief and Health Care Act which was enacted on December 20, 2006. This legislation outlined only the basic requirements. The new IRS notice provides more details on the administrative requirements for these rollover opportunities.

In this *Special Alert*, we will review the new guidance regarding HRA and FSA rollovers, including:

- General requirements
- Specific requirements
- Special rules for rollovers before March 15, 2007

The application of these rollovers is somewhat limited because the general requirements are somewhat restrictive. However, in the instance that you may have individuals who meet the general requirements, we will provide the process for executing these rollovers.

### General Requirements

The new legislation passed last December allows new opportunities for individuals to roll funds into an HSA. The FSA rollovers were primarily permitted to address the problem of a Section 125 grace period disqualifying an individual from contributing to an HSA when initially eligible. Rollovers from a general purpose HRA are also permitted.



In the latest guidance, the IRS renames these rollover transactions. Instead of calling them “rollovers”, they are referred to as “qualified HSA distributions”. This is somewhat confusing since disbursements from HSAs are also referred to as distributions. When you see a reference to a “qualified HSA distribution”, it is referring to a medical FSA or general purpose HRA rollover.

The qualified HSA distribution is a direct distribution of an amount from a health FSA or HRA to an HSA. The transaction must meet the following requirements:

- The rollover amount must not exceed the lesser of the (1) balance in the health FSA or HRA on September 21, 2006 or

(2) the account balance on the date of distribution:

- If an individual is not covered by a medical FSA or HRA as of September 21, 2006, the individual will never be qualified for a rollover from an FSA or HRA to an HSA.
- If an individual is covered by an FSA or HRA as of September 21, 2006, but changes employers after September 21, 2006, the individual is not qualified for a rollover from the second employer.

- The rollover amount must be directly deposited by the employer into the HSA.
- The rollover amount does **not** offset the contribution limit for the year in which it is made.
- Only one rollover of each type of account is permitted in an employee's lifetime.
- The rollover must be made before January 1, 2012.



- The individual must remain eligible during the "testing period" for the rollover to remain tax-favored. The testing period begins the month in which the rollover is deposited into the HSA and ends on the last day of the 12th following month.
- If the individual does not remain eligible during the testing period, the rollover amount is included in gross income and subject to a 10% excise penalty. The new guidance notes while the rollover amount becomes subject to income tax and an excise penalty, the individual is not required to withdraw the amount from the HSA. The notice states these amounts are not considered mistaken contributions, and therefore not eligible to be "withdrawn" from an HSA.

As a result, an individual could actually experience a double tax penalty. The first is the

- penalty that applies by failing to remain covered during the testing period and the second potential tax penalty occurs if an individual takes a distribution from the HSA for a non-qualified medical expense. The amount of the distribution becomes taxable income and, depending on the circumstances, may also result in an additional excise penalty.
- The new notice also explains that if an individual fails to rollover the entire balance at year-end (the individual may not be eligible to rollover the full year-end balance) and remains eligible for benefits under the FSA or HRA while being covered by a qualifying HDHP, that individual will be disqualified from contributing to the HSA. In addition, the employee would also fail the "testing period" because he or she would be ineligible to contribute to the HSA for the twelve months following the rollover.

In addition, the new guidance provides further discussion of the impact of a grace period on a health FSA. One way an individual could contribute to an HSA (even if a health FSA has a grace period) is if the individual has a zero dollar balance at year-end in the FSA. If the only reason the individual could not contribute to an HSA is the FSA grace period and the FSA has a zero balance, the individual can contribute to an HSA during the grace period.

The zero dollar balance refers to the year-end cash balance. It means the account funds need to be exhausted at the end of the plan year. The claims need to be paid out; they cannot be incurred but not reported. They also cannot be pending in your FSA claim payers system.

## Acronyms Aplenty

- **HSA** - Health Saving Accounts (individually owned trust accounts designed for tax-favored savings for health expenses)
- **FSA** - Flexible Spending Accounts (permitted by Section 125 and permits pre-tax savings for eligible medical care expenses)
- **HRA** - Health Reimbursement Arrangements (treated like self-funded medical plans, allows for tax-favored payments on eligible medical expense. Only employer funding permitted.)
- **HDHP** - High Deductible Health Plan (In order to be eligible to contribute to an HSA, an individual needs to be covered by a qualifying HDHP. Parameters are set by the IRS and indexed annually.)

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This IRS Notice does not impact the “use it or lose it” rule if the employer chooses not to add the grace period. If an employer’s FSA does not have a grace period, rollovers are not permitted at year-end.

### Specific Requirements

To allow the rollover, four requirements must be met:

1. The plan must be amended to allow rollovers.
  2. The employee must elect the rollover by year-end.
  3. The year-end account balance must be frozen.
  4. The employer must deposit rollover amount.
1. **Amending the plan:** To allow rollovers from a health FSA or HRA, an employer must amend their written plan document. In order to comply with the comparability requirements, the amended plan must offer the rollover option to any eligible employee under the plan. If an employee requests a rollover, there is no requirement that the FSA or HRA needs to be terminated.

In fact, several examples in the guidance demonstrate that if an individual could not rollover all funds available from an HRA or FSA and remains eligible for benefits from either account (assuming it was not limited scope), this would disqualify the individual from contributing to the HSA. The end result would be the failure to meet the “testing period” requirement. It is also noted that the same issue impacts any mid-year plan launches of qualifying

high deductible health plans. While a rollover may be permitted mid-year, the eligibility for an FSA continues to the end of the plan year (even if no funds are available for use). The zero balance exception only occurs at the end of the plan year. From this perspective, mid-year launches of consumer driven health strategies remain problematic if an FSA is involved.

2. **Employee Electing the Rollover:** The employee must elect the rollover option by the last day of the plan year. Electing the rollover is the easy step. Employers must follow several administrative steps in response to a rollover election:

- If possible, the employer should confirm with the employee that no other rollover election has occurred in his/her lifetime.
- The employer should confirm the employee elected an employer-sponsored high deductible health plan option. The employer should confirm the employee has qualifying HDHP coverage as of the first day of the month in which the rollover deposit is made. To the extent possible, the employer should attempt to confirm the individual is qualified to make HSA contributions (no other coverage, not Medicare enrolled, and so on).



- The employer must determine the amount eligible for the rollover by comparing the year-end balance with the account balance as of September 21, 2006.

3. **Freezing the Account Balance:** If the employee elects the rollover, the employer must freeze the account balance as of the last day of the plan year. That means any claims that are pending or not paid by the vendor by the last day of the plan year, will not be paid by the account (especially true if all of the remaining balance rolls over to the HSA). This is important to note because, if an individual establishes an

HSA at the beginning of the plan year, and any claims are pending under an FSA or HRA, they will have a date of service prior to the creation of the

HSA and will not be eligible expenses under the HSA. The pending claims would not be payable under the FSA, HRA or HSA.

4. **Employer Must Deposit Rollover Amount:** Employers are required to deposit the funds with the HSA vendor as soon as reasonably possible. They must be deposited within 2½ months following the close of the FSA or HRA plan year.

While the rollover option may be attractive, its application is somewhat limited. The process steps are complicated and employers may decide not to allow these rollovers. However, if an employer has already decided to allow rollovers this year,

the next section is very important to make sure the appropriate steps are taken.

### Special Rules for Rollovers Before March 15, 2007

If an employee requested a rollover in early 2007, special rules apply. The special rules were developed for individuals requesting the rollovers before the government provided enough information on the rollover process. If an employee has a balance in a general purpose medical FSA or HRA, the employee may be eligible to contribute to an HSA as of the first day of the first month of 2007 if the following requirements are met:

1. **Amending the Plan:** To allow rollovers from a health FSA or HRA, an employer must amend their written plan document. The plan must be amended by March 15, 2007 to allow January 1 rollovers.
2. **Employee Electing the Rollover:** The employee must elect the rollover option by March 15, 2007. Employers must follow several administrative steps in response to a rollover election:
  - If possible, the employer should confirm with the employee that no rollover

election has occurred in his/her lifetime.

- The employee has qualifying HDHP coverage as of the first day of the month in which the rollover transaction is deposited in the HSA.
- The employer must determine the amount eligible for the rollover by comparing the year-end balance with the account balance as of September 21, 2006.



3. **Freezing the Account Balance:** If the employee elects the rollover, the employer must freeze the account balance as of the last day of the plan year (or the date of the request, providing it is made prior to March 15, 2007).
4. **Employer Must Deposit Rollover Amount:** The employer must deposit the rollover amount directly to the HSA trustee by March 15, 2007.

If employers wish to allow rollover from FSAs or HRAs as of January 1, 2007, they must work quickly to meet the requirements outlined above.

### Conclusion

The new IRS notice is designed to provide more details to employers on how to administer rollover requests from medical FSAs or general purpose HRAs. The IRS notice is confusing but does outline specific steps employers must take to allow these rollover or "qualified distributions". The applicability of these rollovers is fairly limited and somewhat complicated. Organizations may choose not to allow them.

However, it is a way to allow employees to contribute "seed funds" in an HSA and create opportunities to allow HSA eligibility even when an employer has a grace period associated with their FSA.

If you have any questions, please contact your McGraw Wentworth Account Manager. **MW**

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McGraw Wentworth, Inc.  
3331 West Big Beaver Road, Suite 200  
Troy, MI 48084  
Telephone: 248-822-8000 Fax: 248-822-4131  
[www.mcgrawwentworth.com](http://www.mcgrawwentworth.com)