



# SPECIAL Alert

## In This Issue

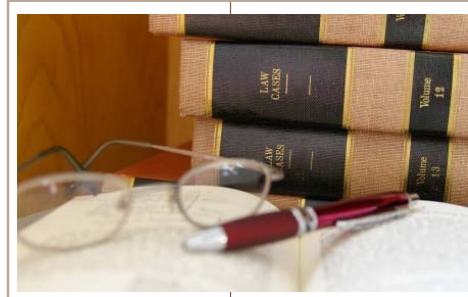
*In this fifth Special Alert for 2008, we will discuss the recently released guidance for Health Savings Accounts (HSAs). One Notice details the requirements for transferring IRA funds into an HSA. The other Notice provides valuable details on determining the annual contribution limit for HSAs.*

*For employers that sponsor high deductible health plans with Health Savings Accounts, these Notices will help answer some of the questions their employees may have.*

*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 McGrawWentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “More Guidance on Health Savings Accounts”

The IRS recently released two notices clarifying some remaining gray areas in Health Savings Accounts (HSAs). HSAs are highly regulated individually owned tax-favored trust or custodial accounts used for health care expenses. Account holders must also have an accompanying high deductible health plan. For more information on health savings accounts, please read our *Benefit Advisor* at [http://www.mcgrawwentworth.com/Benefit\\_Advisor/2007/BA\\_Issue\\_3.pdf](http://www.mcgrawwentworth.com/Benefit_Advisor/2007/BA_Issue_3.pdf).



The IRS has issued the following new HSA guidance on contributions:

- **Notice 2008 – 51:** Requirements for anyone wanting to transfer funds from an IRA (Individual Retirement Account) to an HSA.
- **Notice 2008 – 52:** Information on calculating the annual HSA contribution limit.

This *Special Alert* explains these two notices in depth.

### Notice 2008 – 51: IRA Transfers to HSAs

The *Health Opportunity Patient Empowerment Act* implemented at the end of 2006 allowed people a once per lifetime opportunity to transfer funds from an IRA to an HSA without incurring any early withdrawal penalties.

Funds transferred from IRAs are generally considered gross income with some exceptions. The following rules apply to IRA funds:

- If the IRA owner made non-tax deductible contributions to the IRA, those contributions are recovered on a pro-rata basis and the distribution is partly included and excluded in gross income.
- A non-qualified distribution from a Roth IRA is included in gross income, only to the extent that earnings are distributed. A qualified distribution from a Roth IRA is excluded from gross income.

- If a distribution from an IRA or a Roth IRA is made before the account holder attains age 59 ½, the distribution is also subject to an additional 10% tax penalty unless an exception applies.

The new notice details the rules for withdrawing IRA funds and placing them in an HSA. These rules are fairly complex and apply to some very specific situations; because the rules are so complicated, employers may feel uncomfortable explaining them to their employees. After all, if employees do not follow the rules or do not remain covered throughout the testing period, they may be faced with significant tax consequences. If you are interested in these specifics, you can find the text of the notice at <http://www.irs.gov/pub/irs-drop/n-08-51.pdf>.

While the specific IRA rules can get a bit complex, the guidance does describe the basic requirements for moving money from an IRA to an HSA. In general, money transferred from an IRA to an HSA is not treated as taxable income and early withdrawal penalties do not apply. However, the new guidance clarifies some of the complicated situations that can occur:

- Contributions to an HSA cannot exceed the annual maximum HSA contribution limit for that taxable year. For 2008 the contribution limit is \$2,900 for self only coverage and \$5,800 for family coverage. Catch-up contributions are allowed for anyone over age 55. These annual contribution limits also apply to funds transferred from an IRA.

- Not all IRAs allow account holders to deposit tax-favored funds into an HSA. These rules apply only to traditional IRAs as defined in Section 408 of

the Internal Revenue Code and Roth IRAs. They do not apply to ongoing SIMPLE IRAs and ongoing SEP IRAs. These IRAs are treated as ongoing if an

employer contributes during a plan year ending within the same taxable year in which the IRA owner transfers funds to an HSA.

- After an IRA or Roth IRA account holder dies, a beneficiary can transfer funds to an HSA. The amount withdrawn will count toward the minimum distribution requirement.
- In general, the regulations allow only one transfer from an IRA to an HSA during a person's lifetime. The new guidance

discusses a situation where an employee begins a year with self-only coverage and transfers IRA funds to an HSA. If that employee marries during that same year and the contribution limit increases because the spouse is now covered under the plan, there may be a second transfer in that year. Again, the transferred IRA funds cannot exceed the annual maximum HSA contribution limit.

- The IRA account owner and the HSA account holder must be the same person. People cannot take money from their own IRAs and deposit it into someone else's HSA and not be charged income or penalties.
- If an employee owns more than one IRA and wants to transfer money to an HSA, since only one transfer is allowed per lifetime, the employee would need to make an IRA to IRA transfer and then withdraw the funds from just one IRA.
- When IRA funds are transferred to an HSA, the tax year in which the funds are taken from the IRA becomes an issue. The HSA rule that allows deposits to be made up to the tax-filing deadline to be treated as being made in that tax year does not apply. Although a contribution made to an HSA up to April 15, 2009, can apply to the 2008 tax year, this rule does not apply to funds transferred from an IRA. The IRA funds must be transferred before the end of the calendar year to be treated as being transferred in that year.



## NOTABLE THOUGHTS

**YOU CANNOT TRULY LISTEN TO ANYONE AND DO ANYTHING ELSE AT THE SAME TIME.**

**M. SCOTT PECK**

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The new guidance also clarifies the actual process for transferring funds from an IRA to an HSA. Account holders must meet the following conditions:

- The account holder must be eligible to contribute to the HSA at the time of the transfer.
- The funds withdrawn must be transferred directly from the IRA to the HSA. The account holder can deliver the check, but it must be made payable to the HSA trustee or custodian.

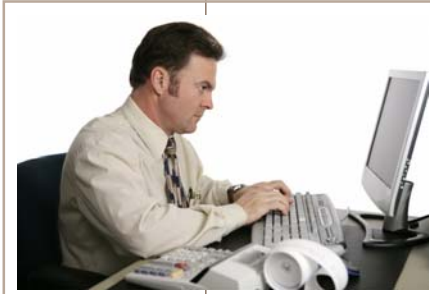
The new guidance also expands on the testing period requirements. In

order for the transferred IRA funds to remain tax-favored, the individual must be eligible to contribute to the HSA throughout the testing period. The testing period begins in the month the funds are actually deposited into the HSA and ends on the last day of the twelfth month following that month. For example, if IRA funds are deposited to the HSA on July 21, 2008, the testing period would end on August 31, 2009.

Following is additional information on the testing period:

- A coverage change during the testing period does not affect the testing period – the key is that the individual remains eligible to contribute to the HSA.

- If an employee becomes ineligible to contribute to an HSA during the testing period, the amount transferred into the HSA is considered taxable income for the tax year the employee is no longer eligible. An additional 10% tax penalty applies unless the employee is no longer eligible to contribute because of death or disability.
- In some cases a double tax penalty may occur. First, a tax



penalty can apply to funds transferred from an IRA if the employee becomes ineligible during the testing period.

Second, if the employee uses HSA funds for expenses not qualified under Section 213(d), those funds are treated as taxable income and an additional 10% penalty applies.

As you can see the rules on transferring IRA funds to an HSA are very confusing. Many HSA vendors would not allow the transfers from IRAs initially because they did not have enough details to determine whether transfers were being made properly. Now that the IRS has released this guidance, it is likely more vendors will allow the once per lifetime transfer from an IRA.

The new IRS guidance gives many examples of various situations to help employees understand the complicated rules for transferring funds from an IRA to an HSA. However, the process is technically difficult.

As an employer, you can offer the new IRS information to your employees, but urge them to consult a tax professional.

### Notice 2008 – 52: Annual Contribution Limits

This notice gives much more detail on calculating HSA contribution limits. It seems relatively straightforward and yet the directions on the Form 8889, which taxpayers with HSAs must complete, have left many questions. The new guidance aims to help answer those questions. What's more the IRS is clarifying the instructions on the updated Form 8889.

The notice explains a number of issues:

- It officially repeals the section of the Medicare legislation on HSA contribution limits. Initially, contribution limits were the lesser of the plan deductible or the IRS set contribution limit. For 2007 and later, the contribution limit is simply the limit the IRS sets, and it is determined by the coverage election (single or family).
- If an employee is eligible to contribute to an HSA as of December 1 (for calendar year taxpayers), the employee's maximum HSA contribution is the greater of:
  - a) The sum of the monthly contribution limits determined on a pro-rata basis based on the plan coverage elected (single/family).

- b) The maximum annual contribution limit based on the coverage the individual has under a high deductible health plan on the first day of the last month of the tax year (typically, December 1).

In both situations, you must include catch up contributions when you determine maximum contribution limits for individuals 55 or older.

This detail was added because of the following situation. Employees may base their contribution limits on their health plan coverage as of December 1, but it is possible that their coverage may change during the year causing their contribution limit to change. For example, if I am eligible to contribute to an HSA as of February 1 and I have family coverage, the family coverage limit applies. However, if I get divorced in November, my coverage status as of December 1 is single. Therefore, calculating my maximum using the first bullet method will result in a higher contribution limit than just simply using my coverage status on December 1<sup>st</sup>.

For the purposes of this section, a testing period applies if the situation falls under the “full contribution” rule. This rule applies when the employee is not eligible for coverage during the full tax year, but is covered as of December 1 and wishes to deposit the full annual HSA contribution, rather than merely the pro-rated amount for the time the employee was actually covered during the year.

- The testing period for the “full contribution” rule begins on the first day of the last month of the tax year and ends the last day of the twelfth month on the following tax year. For most people, the testing period would begin the first day of December and end on December 31 of the following year.

The new guidance also explains the consequences of failing to maintain health plan coverage throughout the testing period:

- If at any time during the testing period, an employee fails to remain eligible to contribute to an HSA, *an amount* is included in the employee’s gross income and that amount is subject to an additional 10% tax, unless the employee is no longer eligible because of disability or death. The employee’s coverage status can change in this time frame without consequence, but the employee must remain eligible to contribute to the HSA.

- The taxable amount depends on the situation. The guidance describes a number of scenarios to help employees calculate the taxable amount. They need to determine what portion of their annual HSA contribution would have been permitted based on their coverage status and the number of months they were eligible to contribute during the tax year. This

amount is not subject to the testing period because it is the amount the employee was eligible to contribute. The employee should take the actual contribution and subtract the permitted amount. The difference is taxed and subject to the 10% tax penalty. The additional 10% tax penalty applies regardless of the account holder’s age.

- Withdrawing this amount from the HSA will not prevent it from being included in income or being subject to the additional 10% tax.
- Earnings on this amount, however, are not included in gross income or subject to the tax penalty.

The guidance also discusses the excise tax on excess HSA deposits. If an employee deposits more than the maximum amount permitted, the excess and any earnings attributed to that amount are subject to a 6% excise tax. Employees can withdraw the excess funds before the end of the tax year to avoid the excise tax. This guidance specifies, however, that any amount included in gross income because the employee failed to remain covered during the testing period is not considered an excess contribution. It cannot be withdrawn under the excess contribution rule and is not subject to the 6% excise tax.



This guidance includes an example where a double tax penalty may occur. If an employee deposits funds in an HSA under the full contribution rule and is not eligible to contribute through the entire testing period, the excess funds become taxable income and are subject to the 10% tax penalty. If an employee withdraws HSA funds for a non-qualified medical expense, those funds are included in income and also subject to a 10% tax penalty. It does not matter if those funds are also subject to tax and the additional penalty for not remaining eligible to contribute to the HSA during the testing period.

This contribution guidance also contains numerous examples of how to determine the maximum contribution limit given a number of different circumstances. The text of the guidance can be found at <http://www.irs.gov/pub/irs-drop/n-08-52.pdf>.

The examples are very helpful and will likely answer many of the questions your employees may have. Remember, HSAs are individually owned and how the account and contributions are handled may have significant tax consequences for your employee.



## Concluding Thoughts

Consumer-driven health plans paired with health savings accounts are a lead strategy many organizations are adopting to help re-involve employees in the cost of care. The plans can be complicated and the HSA tax rules can be confusing. These two latest IRS notices explain more fully how to transfer money from an IRA to an HSA and how to determine the maximum annual HSA contribution allowed.

Both situations are quite complex and each notice includes examples to help taxpayers understand the HSA rules. If you are not comfortable answering complicated questions regarding HSAs, offer this IRS guidance to your employees and recommend they consult a tax professional.

If you have any questions regarding consumer-driven health plans or HSAs, please contact your McGraw Wentworth Account Director. **MW**

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