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## IRS CLARIFICATION AND TRANSITION RELIEF FOR HEALTH FSAs AND HRAs TO HSAs

In December, 2006, we distributed a Legislative Update regarding the Tax Relief and Health Care Act of 2006 (TRHCA), which was to become part of tax bill HR 6111. Since that time, we have been awaiting clarification promised by the Internal Revenue Service (IRS). On February 15, 2007, the IRS posted Notice 2007-22, providing clarification and transition relief for rollovers from Health Flexible Spending Arrangements (FSAs) and Health Reimbursement Accounts (HRAs) to Health Savings Accounts (HSAs).

TRHCA calls these rollovers “qualified HSA distributions”, and allows only one rollover per person from each FSA or HRA before January 1, 2012. Under the TRHCA rules, all of the following conditions must be satisfied in order for an FSA or HRA rollover to be exempt from taxation and an additional 10% tax:

- By the plan year end:
  - the FSA or HRA must be amended;
  - the employee must elect the rollover; and
  - the year-end balance must be frozen.
- The funds must be transferred by the employer within 2½ months after the end of the plan year and must result in a zero balance in the FSA or HRA.
- The maximum amount of the rollover is the lesser of the current available balance in the FSA or HRA or the balance as of September 21, 2006.
- The individual must continue to have high deductible health plan (HDHP) coverage for a testing period of an additional 12 months after the month in which the rollover is made.

Notice 2007-22 provides special transition relief until March 15, 2007, in two respects:

- There is no requirement to freeze the year-end balance in the FSA or HRA.
- The plan amendment, election and transfer requirements are extended until then, instead of the end of the plan year.

Eligible individuals may contribute to an HSA if they are covered by a HDHP as of the first day of the month and are not covered by any other health plan that is not an HDHP. TRHCA and the Notice have not changed the fact that an individual cannot be covered by a general purpose health FSA or HRA and an HSA at the same time. Also, under TRHCA, HRA or FSA rollovers to an HSA do not count against the HSA annual maximum. (Keep in mind that IRA rollovers do).

The Notice provides three sets of examples to clarify how TRHCA works, to explain the transition relief, and to show when rollovers would be taxable and subject to the additional 10% tax.

### TRHCA Clarification

The Notice answers several questions that were previously unclear:

- If an individual was not covered under an FSA or HRA on September 21, 2006, that individual is not eligible for a rollover to an HSA.
- If an individual was covered under an FSA or HRA on September 21, 2006, but later participates in a second employer's FSA or HRA, that individual still is not eligible for a rollover from the second employer's FSA or HRA to an HSA.
- An employer need not terminate the HRA or FSA for a qualified rollover to an HSA. The rollover can occur at the end of the plan year. Then, the individual would need to waive HRA coverage for the next year or not elect FSA coverage. In the alternative, the HRA or FSA can be converted to a limited purpose or post-deductible HRA or FSA.
- Balances for rollovers are determined on a cash basis. This means that expenses that have been incurred but not reimbursed as of the rollover date are not taken into account for purposes of determining the available balance.
- State trust law determines when an HSA is established. Most state trust laws require a trust to be funded to be established.
- Employers are not responsible for reporting whether an employee who makes a rollover to an HSA remains enrolled in the HDHP during the testing period. However, employers must report these rollovers to the HSA trustee, who must report them as a rollover contribution on Form 5498-SA.

### **The Transition Relief**

The Notice spells out the situations where transition relief would apply:

- An individual waits until the middle of an FSA grace period to roll over the remaining balance to the HSA.
- An individual has claims paid during the FSA grace period that were incurred before the end of the plan year and then rolls over the remaining balance to the HSA.

The Notice also clarifies that transition relief would not apply if an individual's FSA account is exhausted during the grace period, regardless of whether the expenses were incurred before or after the end of the plan year.

### **Taxable Rollovers and the Additional 10% Tax**

The Notice identifies situations where a rollover to an HSA would lose its tax qualification and be subject to the additional 10% tax:

- FSA and HRA coverage during the plan year is not disregarded, even if the balance is zero. Thus, a midyear rollover to an HSA will be taxable and subject to the additional 10% tax.
- If the rollover does not result in a zero balance in the FSA or HRA at the end of the plan year, then the rollover will be taxable and subject to the additional 10 percent tax (unless the FSA or HRA becomes limited purpose or post-deductible).
- A change of jobs during the testing period that results in non-HDHP coverage will make the previous rollover taxable and subject to the additional 10-percent tax.

A copy of Notice 2007-22 may be found at <http://waysandmeans.house.gov/ResourceKits.asp?section=2544>. For more information contact your Mesirow Financial representative.

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