

Part III - Administrative, Procedural, and Miscellaneous

Health Savings Accounts

Notice 2007-22

This notice provides guidance on rollovers from health Flexible Spending Arrangements (health FSAs) and Health Reimbursement Arrangements (HRAs) to Health Savings Accounts (HSAs) under amendments to the Internal Revenue Code by section 302 of the Health Opportunity Patient Empowerment Act of 2006 (the Act) included in the Tax Relief and Health Care Act of 2006, enacted December 20, 2006, Pub. L. No. 109-432. *NEW* The guidance also provides special transition relief for rollovers completed before March 15, 2007. It is anticipated that additional guidance will be published later under this provision.

As discussed in detail below, the new rules provide, in limited circumstances, for certain amounts in a health FSA or HRA to be rolled over into an HSA and for the rollover to receive favorable tax treatment. Generally, under the new rules, all of the following conditions must be satisfied in order to receive the favorable tax treatment:

- By plan year end--
 - The plan must be amended
 - The employee must elect the rollover
 - The year-end balance must be frozen
- The funds must be transferred by the employer within two and a half months after the end of the plan year and result in a zero balance in the health FSA or HRA.

Under special transition relief provided in this notice for amounts remaining at the end of 2006, however:

- There is no requirement to freeze the year-end balance in the health FSA or HRA, and
- The amendment, election, and transfer must be completed by March 15, 2007.

BACKGROUND

Eligible individuals, as defined in § 223(c)(1) of the Code, may contribute to HSAs. In general, these are individuals who, as of the first day of the month, are covered by a high deductible health plan (HDHP) and by no other health plan that is not an HDHP (with the exception of certain disregarded coverage, including permitted insurance). An individual covered by a general purpose health FSA or general purpose HRA is not eligible to contribute to an HSA. See Rev. Rul. 2004-45, 2004-1 C.B. 971. If a general purpose health FSA allows reimbursements for expenses incurred during a grace period following the end of the plan year, an otherwise eligible individual participating in the health FSA is generally not eligible to make contributions to an HSA until the first day of the first month following the end of the grace period. The maximum duration of a grace

period is until the fifteenth day of the third month following the end of a plan year. See Notice 2005-42, 2005-1 C.B. 1204. Prior to the Act, this rule applied even if the individual's health FSA had no unused benefits as of the end of the prior year (i.e., the balance in the health FSA was zero as of the last day of the plan year). Notice 2005-86, 2005-2 C.B. 1075. However, coverage by an HSA-compatible health FSA or HRA (limited-purpose health FSA or HRA, post-deductible health FSA or HRA, retirement HRA, or suspended HRA), does not affect an employee's eligibility to contribute to an HSA, including coverage during a health FSA grace period. See Rev. Rul. 2004-45.

HEALTH OPPORTUNITY PATIENT EMPOWERMENT ACT OF 2006 – GENERAL RULES

Section 302(a) of the Act provides for “qualified HSA distributions” before January 1, 2012. A qualified HSA distribution is a direct distribution of an amount from a health FSA or HRA to an HSA. The distribution (rollover to an HSA) must not exceed the lesser of the balance in the health FSA or HRA (1) on September 21, 2006, or (2) as of the date of the distribution. Thus, an individual who was not covered by a health FSA or HRA on September 21, 2006 may not elect a qualified HSA distribution. Similarly, an individual who participated in a health FSA with one employer on September 21, 2006, and participates in a health FSA with a second employer after that date, may not elect a qualified HSA distribution with respect to the second employer's health FSA.

CLARIFY

A qualified HSA distribution must be contributed directly to the HSA trustee by the employer. Qualified HSA distributions may be made from general purpose health FSAs and HRAs, as well as from HSA-compatible health FSAs and HRAs. Only one qualified HSA distribution is allowed with respect to each health FSA or HRA of an individual. Qualified HSA distributions are not taken into account in applying the annual limit for HSA contributions. Qualified HSA distributions are treated as rollovers and thus, are not deductible.

If the individual fails to remain HSA-eligible during the testing period following the distribution, the amount of the rollover is included in gross income and is subject to an additional 10 percent tax. For this purpose, the testing period is defined as the period beginning with the month in which the qualified HSA distribution is contributed to the HSA and ending on the last day of the 12th month following that month. It is not required that an employee be an eligible individual with HDHP coverage in order to have a qualified HSA distribution made on the employee's behalf. However, if an employee is not an eligible individual immediately following the qualified HSA distribution, the amount of the distribution is included in the employee's income and subject to an additional 10 percent tax.

Section 302(b) of the Act provides that only certain health FSA coverage during a grace period is treated as disregarded coverage for the purpose of determining an individual's eligibility to contribute to an HSA. Under new § 223(c)(1)(B)(iii) of the Code, coverage during a grace period by a general purpose health FSA is disregarded if (1) the balance in the health FSA at the end of the prior plan year is zero or (2) the individual makes a

qualified HSA distribution of any balance remaining at the end of the plan year to an HSA.

Section 302(b) of the Act only applies to health FSA coverage during a grace period following a plan year. Thus, health FSA coverage during the plan year is not disregarded, regardless of whether the health FSA balance is reduced to zero during the plan year by a qualified HSA distribution or otherwise.

CLARIFY

QUALIFIED HSA DISTRIBUTIONS

If an employer wants to provide qualified HSA distributions, the employer must amend the health FSA or HRA written plan. In order to comply with the comparability rules in § 4980G of the Code, the amended plan must offer qualified HSA distributions to any otherwise eligible individual covered by the employer's HDHP. See new § 106(e)(5)(B) of the Code. However, there is no requirement that the health FSA or HRA be terminated in order to provide a qualified HSA distribution. Health FSAs and HRAs must satisfy the nondiscrimination requirements in § 105(h) of the Code.

CLARIFY

A qualified HSA distribution may be made at any time prior to January 1, 2012. However, even if the qualified HSA distribution reduces the balance of an FSA or HRA to zero, the health FSA or HRA coverage does not end. If the FSA or HRA is not HSA-compatible, employees can become eligible individuals only after transfers at the end of the plan year of the FSA or HRA that result in either disregarded coverage under 302(b) of the Act, or the termination of the HRA coverage at the end of the plan year. Consequently, qualified HSA distributions from health FSAs or HRAs that are not HSA-compatible and that take place at any time other than the end of a plan year, generally result in the inclusion of the distribution in income and the imposition of an additional 10 percent tax.

CLARIFY

The amendments in the Act do not change the requirement that unused amounts remaining at the end of a health FSA's plan year must be forfeited in the absence of a grace period. Notice 2005-42. Thus, if a health FSA does not have a grace period, unused amounts remaining at the end of the plan year are forfeited and generally cannot be transferred through a qualified HSA distribution to an HSA after the end of the plan year. Although the unused amounts can be distributed to an HSA before the end of the plan year, because the health FSA coverage continues until the end of the plan year, an individual covered by the health FSA is not an eligible individual immediately after the qualified HSA distribution, and thus any such qualified HSA distribution is included in income and subject to an additional 10 percent tax. Similarly, an individual without HDHP coverage after a distribution is not an eligible individual after the distribution and thus the qualified HSA distribution is included in income and subject to an additional 10 percent tax. Unless a participant has a change in status as provided in Treas. Reg. § 1.125-4(a), health FSA elections may not be changed during a plan year. Prop. Treas. Reg. § 1.125-1, Q & A-15.

BALANCES DETERMINED ON CASH BASIS

CLARIFY For all purposes, balances are determined on a cash basis. Cash basis means the balance as of any date, without taking into account expenses incurred that have not been reimbursed as of that date. Thus, pending claims, claims submitted, claims received or claims under review that have not been paid as of a date are not taken into account for purposes of determining the account balance as of that date. In addition, the balance as of any date of a health FSA is determined by applying the uniform coverage rule (i.e., maximum reimbursement available for the plan year reduced for prior reimbursements paid as of the date for the same plan year). See Prop. Treas. Reg. § 1.125-2, Q&A-7(b)(2).

HDHP COVERAGE BEGINNING AFTER 1ST DAY OF THE MONTH

An employee who begins HDHP coverage after the first day of the month is not an eligible individual until the first day of the next month. If a qualified HSA distribution is made on behalf of such an employee before the first day of the next month, the employee is not an eligible individual as of the date of the qualified HSA distribution and the amount of the distribution is included in the employee's income and subject to an additional 10 percent tax. Thus, if an employee begins HDHP coverage after the first day of the month, any qualified HSA distribution on behalf of the individual made on or after the first day of the next month avoids immediate inclusion in income.

CONSEQUENCES OF FAILING TO ROLL OVER ENTIRE BALANCE OF GENERAL PURPOSE HEALTH FSA OR GENERAL PURPOSE HRA

CLARIFY An employee with a balance in a health FSA with a grace period or HRA at the end of a plan year is not treated as an eligible individual for HSA purposes on the first day of the immediately following plan year if a qualified HSA distribution does not result in a zero balance in the health FSA or HRA. Because the employee is covered under a health plan that is not an HDHP during the testing period, the amount of the qualified HSA distribution is included in the employee's gross income in the year of the distribution and is subject to a 10 percent additional tax. However, an employee with a balance in an HSA-compatible health FSA or HRA at the end of a plan year remains an eligible individual, if otherwise eligible, regardless of whether a qualified HSA distribution is made.

ADDITIONAL TAX FOR FAILURE TO REMAIN AN ELIGIBLE INDIVIDUAL

If an individual ceases to be an eligible individual during the testing period, the amount of the qualified HSA distribution is included in the gross income of the individual and subject to an additional 10 percent tax. Failing to remain an eligible individual does not require the withdrawal of the qualified HSA distribution, and the amount is not an excess contribution. However, any HSA withdrawal not used for qualified medical expenses is included in income and subject to an additional 10 percent tax (with certain exceptions), regardless of whether the HSA received a qualified HSA distribution that was previously

included in the account beneficiary's income and subject to the additional tax. See § 223(f)(4)(B).

TRHCA

PERMANENT RULE -- INDIVIDUALS WITH A ZERO BALANCE IN GENERAL PURPOSE HEALTH FSA ON THE LAST DAY OF PLAN YEAR

Under the Act, if an individual has a zero balance in a general purpose health FSA, as determined on a cash basis, on the last day of the health FSA plan year, the individual does not fail to be an eligible individual as of the first day of the immediately following health FSA plan year because of coverage during a health FSA grace period.

TRHCA

PERMANENT RULE -- INDIVIDUALS WITH A ZERO BALANCE IN GENERAL PURPOSE HRA ON THE LAST DAY OF PLAN YEAR

An individual with a zero balance in a general purpose HRA, determined on a cash basis, on the last day of the HRA plan year, does not fail to be an eligible individual on the first day of the immediately following HRA plan year, so long as (1) effective on the first day of the immediately following HRA plan year, the employee elects to waive participation in the HRA, or (2) effective on or before the first day of the following HRA plan year, the employer terminates the general purpose HRA with respect to all employees, or (3) effective on or before the first day of the following HRA plan year, with respect to all employees, the employer converts the general purpose HRA to an HSA-compatible HRA, as described in Rev. Rul. 2004-45.

TRHCA

PERMANENT RULE -- PLAN-YEAR-END ROLLOVERS FROM GENERAL PURPOSE HEALTH FSA OR GENERAL PURPOSE HRA TO HSA

An employee with a balance in a general purpose health FSA with a grace period or general purpose HRA at the end of a health FSA or HRA plan year (plan year) is treated as an eligible individual for HSA purposes as of the first day of the first month in the immediately following plan year that the individual has HDHP coverage on the first day of the month if:

- (1) the employer amends the health FSA or HRA written plan effective by the last day of the plan year to allow a qualified HSA distribution,
- (2) a qualified HSA distribution from the health FSA or HRA has not been previously made on behalf of the employee with respect to that particular health FSA or HRA,
- (3) the employee has HDHP coverage as of the first day of the month during which the qualified HSA distribution occurs, and is otherwise an eligible individual,
- (4) the employee elects by the last day of the plan year to have the employer make a qualified HSA distribution from the health FSA or HRA to the HSA of the employee,

(5) the health FSA or HRA makes no reimbursements to the employee after the last day of the plan year,

(6) the employer makes the qualified HSA distribution directly to the HSA trustee by the fifteenth day of the third calendar month following the end of the immediately preceding plan year, but after the employee becomes HSA-eligible,

(7) the qualified HSA distribution from the health FSA or HRA does not exceed the lesser of the balance of the health FSA or HRA on (a) September 21, 2006, or (b) the date of the distribution, and

(8)(a) after the qualified HSA distribution there is a zero balance in the health FSA or HRA, and the employee is no longer a participant in any non-HSA compatible health plan or (b) effective on or before the date of the first qualified HSA distribution the general purpose health FSA or general purpose HRA written plan is converted to an HSA-compatible health FSA or HRA, as described in Rev. Rul. 2004-45, for all participants.

TRANSITION RULE -- QUALIFIED HSA DISTRIBUTIONS FROM GENERAL PURPOSE HEALTH FSA AND GENERAL PURPOSE HRA BEFORE MARCH 15, 2007

An employee with a balance in a general purpose health FSA or general purpose HRA after December 31, 2006 is treated as an eligible individual for HSA purposes as of the first day of the first month in 2007 that the employee has HDHP coverage on the first day of the month if:

Exception (1) the employer amends the health FSA or HRA written plan effective on or before March 15, 2007, to allow a qualified HSA distribution,

(2) a qualified HSA distribution from the health FSA or HRA has not been previously made on behalf of the employee with respect to that particular health FSA or HRA,

(3) the employee has HDHP coverage as of the first day of the month during which the qualified HSA distribution occurs, and is otherwise an eligible individual,

Exception (4) the employee elects on or before March 15, 2007, to have the employer make a qualified HSA distribution from the health FSA or HRA to the HSA of the employee,

(5) the qualified HSA distribution from the health FSA or HRA does not exceed the lesser of the balance of the respective health FSA or HRA on (a) September 21, 2006, or (b) the date of the distribution,

(6) the employer makes the qualified HSA distribution directly to the HSA trustee by March 15, 2007, but after the employee becomes HSA-eligible, and

Exception on amount???

(7)(a) after the qualified HSA distribution there is a zero balance in the health FSA or HRA, and the employee is no longer a participant in any non-HSA compatible health plan or (b) effective on or before the date of the first qualified HSA distribution, the general purpose health FSA or general purpose HRA written plan is converted to an HSA-compatible health FSA or HRA, as described in Rev. Rul. 2004-45, for all participants.

EXAMPLES

The following examples illustrate these rules. All references to balances in the following examples are determined on a cash basis. All grace periods satisfy the requirements of Notice 2005-42. It is assumed in the examples that, for purposes of § 106(e)(3)(B) and § 223(f)(4)(B), no employees are disabled.

Permanent Rule Examples

Example 1. For 2007, Employer Z has a calendar year general purpose health FSA with a grace period ending March 15, 2008. For 2007, Employee A timely elects salary reduction of \$500 for the general purpose health FSA. Employer Z offers employees the option of electing HDHP coverage for the plan year beginning January 1, 2008. On or before December 31, 2007, A elects HDHP coverage beginning January 1, 2008. On December 31, 2007, A has a zero balance in the health FSA. A is otherwise an eligible individual on January 1, 2008.

A does not fail to be an eligible individual on January 1, 2008 merely because of the health FSA grace period.

Example 2. For 2007, Employer Y has a calendar year general purpose health FSA with a grace period ending on March 15, 2008. Employer Y offers employees the option of electing HDHP coverage for the plan year beginning January 1, 2008.

Before January 1, 2008, Employer Y amends the health FSA to allow for qualified HSA distributions. The amended plan allows an employee electing HDHP coverage to also elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the year-end balance is the balance of the health FSA without regard to any expenses incurred but not paid. Under the amendment, if an employee elects the qualified HSA distribution, the employee cannot submit any additional claims after December 31, 2007, regardless of when the underlying expense was incurred nor are any claims paid after December 31, 2007 even if submitted prior to December 31, 2007.

Employee B has a balance of \$950 in the health FSA on September 21, 2006, and a balance of \$700 on December 31, 2007. On or before December 31, 2007, B elects HDHP coverage beginning January 1, 2008. B also elects to have a qualified HSA distribution of the \$700 remaining in the health FSA on December 31, 2007. Employer

TRHCA, no
rollover/no
FSA: OK

TRHCA,
FSA w/ gp:
B rolls over
all, 1/1/08,
distrib. OK
C doesn't
roll over
balance,
4/1/08

Y contributes \$700 to an HSA on behalf of B on or before March 15, 2008. B is otherwise an eligible individual as of January 1, 2008.

Employee C has a balance of \$850 on December 31, 2007. On or before December 31, 2007, C elects HDHP coverage for 2008. C does not elect to have a qualified HSA distribution of the \$850 remaining in the health FSA on December 31, 2007. C is otherwise an eligible individual.

B does not fail to be an eligible individual as of January 1, 2008 because after the qualified HSA distribution B has a zero balance in the health FSA. C is an eligible individual on April 1, 2008.

Example 3. For 2007, Employer W has a calendar year general purpose HRA. Employer W offers employees the option of electing HDHP coverage for the plan year beginning January 1, 2008.

Before January 1, 2008, Employer W amends the HRA to allow for qualified HSA distributions. The amended HRA allows an employee electing HDHP coverage for the plan year to also elect to have the lesser of the balance in the HRA on September 21, 2006 or the HRA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the year-end balance is the balance of the HRA without regard to any expenses incurred but not paid. Under the amendment, if an employee elects the qualified HSA distribution, the employee cannot submit any additional claims after December 31, 2007, regardless of when the underlying expense was incurred, nor will the HRA reimburse any claim submitted but unpaid as of December 31, 2007. The amendment also provides that an employee who elects a qualified HSA distribution may also elect to waive participation in the HRA.

Employee D has a balance of \$300 in the HRA on September 21, 2006, and a balance of \$175 on December 31, 2007. On or before December 31, 2007, D elects HDHP coverage for 2008. D also elects to have a qualified HSA distribution of the \$175 remaining in the HRA on December 31, 2007, and to waive participation in the HRA effective after December 31, 2007. Employer W contributes \$175 to an HSA on behalf of D on or before March 15, 2008. D is otherwise an eligible individual as of January 1, 2008.

Employee E has a balance of \$300 in the HRA on September 21, 2006, and a balance of \$550 on December 31, 2007. On or before December 31, 2007, E elects HDHP coverage for 2008. E also elects to have a qualified HSA distribution of the \$300 that was in the HRA on September 21, 2006. Employer W contributes \$300 to an HSA on behalf of E on March 15, 2008. E is otherwise an eligible individual as of January 1, 2008.

Employee F has a balance of \$400 in the HRA on September 21, 2006. On or before December 31, 2007, F elects HDHP coverage for 2008. On June 15, 2008, F has a balance of \$275 in the HRA, and elects to have a qualified HSA distribution of the \$275.

TRHCA,
HRA:
D rolls over
all, waives
part., distrib.
OK
E rolls over
less than all,
distrib. is
taxable +
10%
F rolls over
all mid-year,
distrib. is
taxable +
10%

Employer W contributes \$275 to an HSA on behalf of F on August 20, 2008. F is otherwise an eligible individual as of January 1, 2008.

D does not fail to be an eligible individual as of January 1, 2008 because after the qualified HSA distribution D has a zero balance in the HRA and does not participate in any non-HSA compatible HRA. E fails to be an eligible individual after the qualified HSA distribution, because E has a balance exceeding zero in the HRA after the distribution. E must include \$300 in gross income in 2008, as well as pay an additional 10 percent tax. F fails to be an eligible individual after the qualified HSA distribution, because F remains a participant in an HRA that is not HSA-compatible until the end of the HRA plan year. The result is the same regardless of whether F waived participation in the HRA after June 15, 2008. Thus, F must include \$275 in gross income in 2008, as well as pay an additional 10 percent tax.

Example 4. The same facts as Example 3, except Employer W converted the general purpose HRA to an HSA-compatible retirement HRA for all employees effective January 1, 2008.

TRHCA,
HRA goes
to ltd pur.,
distrib. OK
even if
balance
remains

Employee G has a balance of \$275 in the HRA on September 21, 2006, and a balance of \$700 on December 31, 2007. On or before December 31, 2007, G elects HDHP coverage beginning January 1, 2008. G is otherwise an eligible individual as of January 1, 2008. G also elects to have a qualified HSA distribution of the \$275 that was in the HRA on September 21, 2006. Employer W contributes \$275 to an HSA on behalf of G on or before March 15, 2008. G has a balance of \$425 in a retirement HRA and remains an active employee.

G is an eligible individual as of January 1, 2008, because the HRA G participates in is HSA-compatible.

Example 5. Employer V has a fiscal year general purpose health FSA with a grace period. The fiscal year of the health FSA is October 1 – September 30. The grace period ends on December 15. For the plan year beginning October 1, 2007, Employer V offers employees the option of electing HDHP coverage.

TRHCA,
fiscal-yr
FSA w/ gp:
H rolls over
all, distrib.
OK

In December 2006, Employer V amends the health FSA to allow for qualified HSA distributions. The amended plan allows an employee electing HDHP coverage for the plan year to also elect to have any health FSA balance at the end of the plan year, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the plan-year-end balance is the balance of the health FSA without regard to any expenses incurred but not paid. If an employee elects the qualified HSA distribution, the employee cannot submit any additional claims after September 30, 2007, regardless of when the underlying expense was incurred. The health FSA does not reimburse claims submitted but unpaid as of September 30, 2007.

Employee H has a balance of \$600 in the health FSA on September 21, 2006, and a balance of \$500 on September 30, 2007. On or before September 30, 2007, H elects

HDHP coverage for the plan year beginning October 1, 2007. H also elects to have a qualified HSA distribution of the \$500 remaining in the health FSA on September 30, 2007. Employer V contributes \$500 to an HSA on behalf of H on or before December 15, 2007. H is otherwise an eligible individual as of October 1, 2007.

H does not fail to be an eligible individual as of October 1, 2007 because after the qualified HSA distribution H has a zero balance in the health FSA.

Example 6. The same facts as Example 5, except Employer V has a limited purpose health FSA.

TRHCA,
fiscal-yr, ltd
pur. FSA w/
gp:
I rolls over,
keeps bal,
distrib. OK

Employee I has a balance of \$2,000 in the limited purpose health FSA on September 21, 2006, and a balance of \$3,000 on September 30, 2007. On or before September 30, 2007, I elects HDHP coverage for the plan year beginning October 1, 2007. I also elects to have a qualified HSA distribution of \$2,000 that was in the health FSA on September 21, 2006. Employer V contributes \$2,000 to an HSA on behalf of I on or before December 15, 2007. I has a balance of \$1,000 in a limited purpose health FSA. I is otherwise an eligible individual as of October 1, 2007.

I does not fail to be an eligible individual because I participates in an HSA-compatible health FSA.

Example 7. For 2007, Employer U has a calendar year general purpose health FSA with a grace period ending on March 15, 2008. Employer U has a fiscal year health plan that begins July 1, 2007. For the plan year beginning July 1, 2007, Employer U offers employees the option of electing HDHP coverage.

TRHCA,
FSA:
J rolls over
all mid-year,
distrib. is
taxable +
10% b/c
FSA part.
continues
until end of
plan year

Before January 1, 2008, Employer U amends the health FSA to allow for qualified HSA distributions. The amended plan allows an employee electing HDHP coverage to also elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the year-end balance is the balance of the health FSA without regard to any expenses incurred but not paid. Under the amendment, if an employee elects the qualified HSA distribution, the employee cannot submit any additional claims after December 31, 2007, regardless of when the underlying expense was incurred. The health FSA does not pay claims submitted but unpaid as of December 31, 2007.

Employee J has a balance of \$500 in the health FSA on September 21, 2006, and a balance of \$400 on June 30, 2007. On or before June 30, 2007, J elects HDHP coverage for the immediately following health plan year. J also elects to have a qualified HSA distribution of \$400 that was in the health FSA on June 30, 2007. Employer U contributes \$400 to an HSA on behalf of J on or before September 15, 2007. J is an otherwise eligible individual as of July 1, 2007.

J fails to be an eligible individual after the distribution because J's participation in a health FSA is not disregarded coverage until January 1, 2008, even though the qualified

HSA distribution reduces the balance of the health FSA to zero. J must include \$400 in his gross income for 2007, and pay an additional 10 percent tax. J is an eligible individual on January 1, 2008.

Example 8. For 2007, Employer T has a calendar year general purpose health FSA with a grace period ending on March 15, 2008. Employer T offers employees the option of electing HDHP coverage for the plan year beginning January 15, 2008.

Before January 1, 2008, Employer T amends the health FSA to allow for qualified HSA distributions. The amended plan allows an employee electing HDHP coverage to also elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the year-end balance is the balance of the health FSA without regard to any expenses incurred but not paid. Under the amendment, if an employee elects the qualified HSA distribution, the employee cannot submit any additional claims after December 31, 2007, regardless of when the underlying expense was incurred. The health FSA does not pay claims submitted but unpaid as of December 31, 2007.

Employee K has a balance of \$1,000 in the health FSA on September 21, 2006, and a balance of \$700 on December 31, 2007. On or before December 31, 2007, K elects HDHP coverage for the plan year beginning January 15, 2008. K also elects to have a qualified HSA distribution of the \$700 remaining in the health FSA on December 31, 2007. Employer T contributes \$700 to an HSA on behalf of K after February 1, 2008, but before March 15, 2008. K is otherwise an eligible individual as of January 15, 2008.

Employee L has a balance of \$175 in the health FSA on September 21, 2006, and a balance of \$150 on December 31, 2007. On or before December 31, 2007, L elects HDHP coverage for the plan year beginning January 15, 2008. L also elects to have a qualified HSA distribution of the \$150 remaining in the health FSA on December 31, 2007. Employer T contributes \$150 to an HSA on behalf of L on January 25, 2008.

K does not fail to be an eligible individual because K has a zero balance in the health FSA after the qualified HSA distribution. K is eligible to contribute to the HSA as of February 1, 2008. L is not an eligible individual at the time of the distribution because L does not have HDHP coverage on the first day of January. L must include \$150 in gross income in 2008, and pay an additional 10 percent tax. As of February 1, 2008, L is an eligible individual because L has HDHP coverage and no other health plan coverage that is not an HDHP, is not enrolled in Medicare, and cannot be claimed as a dependent on another person's tax return.

Transition Rule Examples

Example 9. For 2006, Employer S has a calendar year general purpose health FSA with a grace period ending on March 15, 2007. Employer S offers employees the option of electing HDHP coverage for the plan year beginning January 1, 2007.

TRHCA,
FSA:
K rolls over
all, distrib.
occurs after
HDHP starts,
distrib. is OK
L rolls over
all, distrib.
occurs
before
HDHP starts,
distrib. is
taxable +
10%

Trans.
Relief, FSA:
M's balance
goes to \$0
during gp,
4/1/07
N has
expenses
during gp,
rolls over
remaining
balance
during gp,
OK b/c \$0
balance after
distrib.
O rolls over
remaining
balance
during gp,
OK b/c \$0
balance after
distrib.

Employer S amends the health FSA to allow for qualified HSA distributions. The amended plan allows an employee electing HDHP coverage to also elect to have any health FSA balance at year-end, determined on a cash basis, contributed directly to an HSA trustee for the employee. For this purpose, the year-end balance is the balance of the health FSA without regard to any expenses incurred but not paid. During the period from January 1, 2007 to March 15, 2007, an employee electing HDHP coverage for 2007 may elect a qualified HSA distribution of the health FSA balance. The amount of the qualified HSA distribution is determined on a cash basis on the date of the distribution.

Employee M has a balance of \$850 on December 31, 2006. On or before December 31, 2006, M elects HDHP coverage beginning January 1, 2007. M does not elect to have a qualified HSA distribution of the \$850 remaining in the health FSA on December 31, 2006. M incurred \$850 of § 213(d) expenses after January 1 and the health FSA reimbursed M for that amount. M's health FSA balance is zero on January 22, 2007. M is otherwise an eligible individual as of January 1, 2007.

Employee N has a balance of \$800 in the health FSA on September 21, 2006, and a balance of \$200 on December 31, 2006. On or before December 31, 2006, N elects HDHP coverage beginning January 1, 2007. During January 2007, the health FSA reimburses N for \$50 in § 213(d) medical expenses. On February 12, 2007, N elects to have a qualified HSA distribution of the remaining health FSA balance of \$150. Employer S contributes \$150 to an HSA on behalf of N on or before March 15, 2007. N is otherwise an eligible individual as of January 1, 2007.

Employee O has a balance of \$300 in the health FSA on September 21, 2006, and a balance of \$175 on December 31, 2006. On or before December 31, 2006, O elects HDHP coverage for 2007. On or before March 15, 2007, O also elects to have a qualified HSA distribution of the \$175 remaining in the health FSA on December 31, 2006. Employer S contributes \$175 to an HSA on behalf of O on or before March 15, 2007. O is otherwise an eligible individual as of January 1, 2007.

Trans.
Relief, FSA:
M's claims
pd during
gp, incurred
during plan
yr, 4/1/07
N's claims
pd during
gp, incurred
during plan
yr, rolls over
remaining
balance
during gp,
OK b/c \$0
balance after
distrib.

M has disqualifying coverage by the health FSA until April 1, 2007 because M neither had a zero balance in the FSA on December 31, 2006 nor did M have a zero balance following a qualified HSA distribution on or before March 15, 2007. N is an eligible individual as of January 1, 2007 because after the qualified HSA distribution N has a zero balance in a health FSA. O is an eligible individual as of January 1, 2007, because after the qualified HSA distribution O has a zero balance in a health FSA.

Example 10. The same facts as Example 9, except M and N incurred their respective \$850 and \$50 in § 213(d) medical expenses in December 2006. M and N submitted the expenses and were reimbursed from the health FSA for the expenses after January 1, 2007 and before February 1, 2007. On February 12, 2007, N elects to have a qualified HSA distribution of the remaining health FSA balance of \$150. Employer S contributes \$150 to an HSA on behalf of N on or before March 15, 2007. N is otherwise an eligible individual as of January 1, 2007.

M has disqualifying coverage by the health FSA until April 1, 2007, because M neither has a zero balance in the FSA on December 31, 2006 nor did M have a zero balance following a qualified HSA distribution on or before March 15, 2007. N is an eligible individual as of January 1, 2007 because after the qualified HSA distribution N has a zero balance in a health FSA.

Examples of Additional 10 Percent Tax

Example 11. Employee P, who is 32 years old, has HDHP coverage as of January 1, 2008. P elects to have a qualified HSA distribution on or before December 31, 2007. On or before March 15, 2008, P's employer contributes \$250 from a general purpose health FSA to an HSA on behalf of P in a qualified HSA distribution meeting the requirements of section 302 of the Act and this Notice. Following the qualified HSA distribution, P has a balance of zero in the general purpose health FSA.

10% tax,
FSA:
P changes
jobs w/i 12
mos of
distrib., does
not have
HDHP @
new job,
taxable &
10% tax.

In July 2008, P terminates employment with Employer R, and begins employment with Employer Q. Employer Q does not offer an HDHP. P obtains health coverage under a low deductible health plan, and ceases to be an eligible individual for HSA purposes. P must include the \$250 qualified HSA distribution in his gross income for 2008, and pay an additional 10 percent tax under § 106(e)(3) of the Code. P does not have to withdraw the \$250 from his HSA, and the amounts in the HSA may grow tax-free.

Example 12. The same facts as Example 11, except in February 2009, P uses \$200 from his HSA for a nonqualified medical expense. The \$200 is included in P's gross income for 2009 and is subject to an additional 10 percent tax under § 223(f)(4) of the Code.

10% tax,
FSA:
taxable &
10% tax if
distrib is for
nonqual'd
med.
expense.

Example 13. The same facts as Example 12, except P uses \$200 from his HSA for a qualified medical expense. The \$200 is not included in P's gross income, and there is no additional tax.

10% tax,
FSA:
OK if distrib
is for qual'd
med.
expense.

NO EFFECT ON HSA ESTABLISHMENT DATE

Qualified medical expenses for HSA purposes are only expenses incurred after the HSA is established. Notice 2004-2, 2004-1 C.B. 269, Q&A-26. While this notice provides that certain individuals are treated as eligible individuals as of the first day of the plan year, those rules do not treat an HSA as established before the actual establishment of the HSA.

State trust law determines when an HSA is established. Most state trust laws require that for a trust to exist, an asset must be held in trust; thus, most state trust laws require that a trust must be funded to be established.

CLARIFY

REPORTING

CLARIFY

Amounts transferred through a qualified HSA distribution are not reported in box 12 of Form W-2. Employers are not responsible for reporting whether an employee receiving a qualified HSA distribution remains an eligible individual during the testing period. However, employers must report qualified HSA distributions as rollover contributions to the HSA trustee, and the HSA trustee must report the qualified HSA distribution as a rollover contribution on Form 5498-SA.

EFFECTIVE DATE

The provision in the Act allowing qualified HSA distributions from health FSAs and HRAs is effective on or after December 20, 2006, and before January 1, 2012.

EFFECT ON OTHER DOCUMENTS

Published guidance under § 105(b) states that if any person has the right to receive cash or any other taxable or nontaxable benefit under a health FSA or HRA, other than the reimbursement of § 213(d) medical expenses of the employee, employee's spouse or employee's dependents, then all distributions made from the arrangement are included in the employee's gross income, even amounts paid to reimburse medical care. See Rev. Rul. 2006-36, 2006-36 I.R.B. 353; Rev. Rul. 2005-24, 2005-1 C.B. 892; Rev. Rul. 2003-102, 2003-2 C.B. 559; Notice 2002-45, 2002-2 C.B. 93; Rev. Rul. 2002-41, 2002-2 C.B. 75; Rev. Rul. 69-141, 1969-1 C.B. 48. New § 106(e) provides that a health FSA or HRA will not fail to satisfy the requirements of §§ 105 or 106 merely because the plan provides for a qualified HSA distribution. Amounts rolled into an HSA may be used for purposes other than reimbursing the § 213(d) medical expenses of the employee, spouse or dependents. Accordingly, Rev. Rul. 2006-36, Rev. Rul. 2005-24, Rev. Rul. 2003-102, Notice 2002-45, Rev. Rul. 2002-41, and Rev. Rul. 69-141 are modified with respect to qualified HSA distributions described in § 106(e). In addition, Notice 2005-86, 2005-2 C.B. 1075, is modified effective as of December 20, 2006.

DRAFTING INFORMATION

The principal author of this notice is Leslie R. Paul of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice contact Ms. Paul at (202) 622-6080 (not a toll-free call).