

**SUMMARY OF NOTICE 2007-22 REGARDING NEW HEALTH SAVINGS ACCOUNT (“HSA”)  
PROVISIONS AS CONTAINED IN THE TAX RELIEF AND HEALTH CARE ACT OF 2006**

On February 15, 2007, the IRS issued Notice 2007-22 pertaining to Health Savings Accounts (“HSAs”). The guidance addresses several new provisions that were added to the Internal Revenue Code (“Code”) as part of the Tax Relief and Health Care Act of 2006 (the “Act”), including the ability to make a Qualified HSA Distribution of existing amounts from a Health Reimbursement Arrangement (“HRA”) or Health Flexible Spending Arrangement (“FSA”) into an HSA. Highlights of the guidance include the following:

➤ **General Rule For Consolidation of Balances in HRAs and FSAs with a Grace Period.**

Coverage under a general purpose FSA with grace period coverage or a general purpose HRA disqualifies an individual from being eligible for HSA contributions. The Notice outlines the relief provided in the Act, which allows a Qualified HSA Distribution to be made from an FSA or an HRA. The Notice provides that in order for an individual to be treated as not having disqualifying coverage from a general purpose FSA (including an FSA grace period) or a general purpose HRA, a Qualified HSA Distribution must meet the following requirements:

- An employer must amend the FSA or HRA written plan effective by the last day of the plan year to allow a Qualified HSA Distribution;
- A Qualified HSA Distribution from the FSA or HRA must not previously have been made on behalf of an employee with respect to that particular FSA or HRA;
- The employee must have qualifying high deductible health plan (“HDHP”) coverage as of the first day of the month during which the Qualified HSA Distribution occurs, and must otherwise be an HSA-eligible individual;
- The employee must elect by the last day of the plan year to have his or her employer make a Qualified HSA Distribution from the FSA or HRA to his or her HSA;
- The FSA or HRA must make no reimbursements to the employee after the last day of the plan year;
- The employer must make the Qualified HSA Distribution directly to the HSA trustee no later than 2-1/2 months following the end of the immediately preceding plan year, but after the employee becomes HSA-eligible;
- A Qualified HSA Distribution must not exceed the lesser of the balance in the FSA or HRA on (i) September 21, 2006, or (ii) the date of the distribution; and
- Immediately following the Qualified HSA Distribution, the FSA or HRA must have a zero balance, and the employee must no longer be a participant in any non-HSA compatible health plan. Alternatively, effective on or before the date of the first Qualified HSA Distribution, the FSA or HRA must be converted to an HSA-compatible FSA or HRA.

*Comment: Under the guidance, mid-year consolidations of general purpose FSAs (including those with grace period coverage) and HRAs generally will result in taxation and penalty for accountholders. This is because, the coverage under the general purpose FSA or HRA is deemed to continue for the duration of the FSA or HRA plan year, even if amounts are “zeroed down” pursuant to a consolidation. Such coverage would be disqualifying other coverage for purposes of the eligibility rules applicable to HSAs. See below for a further discussion of the tax treatment applicable to mid-year consolidations.*

*The guidance also reflects the Service’s view that all consolidations with respect to general purpose FSAs without grace period coverage generally will result in taxation and penalty for accountholders, even where the consolidation is timed for the end of the plan year.*

*The Notice appears to give employees certain discretion with respect to the consolidation of existing FSA or HRA amounts into an HSA if the employer provides the opportunity to*

*consolidate the accounts. Specifically, the Notice states that the employee “must elect” by the last day of the plan year to have his or her employer make a Qualified HSA Distribution from the FSA or HRA to his or her HSA. Query whether a negative election would comport with the Notice (i.e., the employer will consolidate unless the individual employee opts out of the consolidation).*

*The Notice appears to preclude the use of administrative run-out periods with respect to general purpose HRAs and FSAs that, absent a Qualified HSA Distribution, would result in disqualifying coverage for the plan year in which a consolidation would occur. This is because the Notice expressly states that “the FSA or HRA must make no reimbursements to the employee after the last day of the plan year.”*

- **Transition Rule for Consolidation of Amounts Remaining at the End of 2006.** The Notice provides transition relief for Qualified HSA Distributions pertaining to amounts in FSAs and HRAs as of December 31, 2006.
  - These arrangements need not have been “frozen” as of December 31, 2006, under the general rules for Qualified HSA Distributions discussed above.
  - Under the transition rule for 2006, distributions that have occurred under an FSA grace period during 2007 or that have occurred from an HRA during 2007, will not cause the individual to be ineligible for HSA contributions from January through March 2007, provided that the Qualified HSA Distribution from the FSA or the HRA occurs no later than March 15, 2007, and consists of all amounts remaining in such FSA or HRA as of the date of the Qualified HSA Distribution (but not in excess of the September 21, 2006 balance).

*Comment: In contrast to the general rule, the transition relief does not require that the employer have frozen an employee’s FSA or HRA account balance as of the close of the 2006 plan year. Thus, it appears that employers may resurrect HRA balances that may have been forfeited or otherwise terminated at year-end by employees who were seeking to be HSA-eligible as of January 1, 2007. Note that an employer could not resurrect an FSA balance that forfeited on December 31, 2006, since an FSA without a grace period must forfeit any remaining funds under the “use-it-or-lose-it” rule.*

- **If an Employer Offers Consolidation, the Employer is Required To Offer Consolidation to All HSA-Eligible Employees.** The Notice provides that an employer must offer to “any otherwise eligible individuals covered by the employer’s HDHP” the option to consolidate existing medical reimbursement accounts into an HSA.

*Comment: On its face, the Notice does not appear to require that employers offer consolidations to employees with HDHP coverage not otherwise sponsored by the employer.*

- **No “De Minimis” Rule for Amounts Remaining in FSA or HRA Following Consolidation.** The Notice provides that an individual is deemed to have other disqualifying coverage where, immediately following a Qualified HSA Distribution, the individual’s account balance in his or her general purpose FSA or general purpose HRA is more than zero. The result of having disqualifying coverage is that the Qualified HSA Distributions are subject to immediate income inclusion and a 10 percent penalty on contributed amounts.

*Comment: The Notice does not on its face permit individuals to disregard low-dollar or otherwise “de minimis” amounts remaining in a general purpose FSA or HRA immediately following consolidation. The lack of a de minimis rule could raise some significant administrative issues.*

- **HDHP Coverage Beginning After the Start of the Month.** The Notice states that an employee who becomes covered by an HDHP after the first day of the month is not an HSA-eligible individual until the first day of the proceeding month. The Notice states, therefore, that 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 consolidation and contributed amounts are subject to immediate income taxation and penalty.
- **Mid-Year Consolidations of General Purpose FSAs and HRAs Result in Taxation and Penalty For Accountholders.** The Notice states that even if a Qualified HSA Distribution reduces the balance of an FSA or HRA to zero, the coverage provided under a general purpose FSA or HRA continues for the duration of the plan year. Such coverage is deemed to be other disqualifying coverage for purposes of the HSA rules. This means that if a Qualified HSA Distribution of such amounts occurs during the middle of the plan year, the consolidation would result in income inclusion and a 10 percent penalty for accountholders. To avoid this result, Qualified HSA Distributions of general purpose FSAs and HRAs should occur at the end of the plan year.
- **Account Balance Determined on Cash Basis “For All Purposes.”** The Notice states that “for all purposes, balances are determined on a cash basis.” The term “cash basis” is defined to mean “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 given date (*i.e.*, the end of the plan year) are not taken into account for purposes of determining the account balance as of that date. The Notice further notes that an FSA balance as of any date 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).

*Comment: A cash basis definition will, however, pose some difficulties for employers and administrators with respect to the administration of the “Zero Balance Rule” (see below).*

- **Guidance Regarding Zero Balance Rule.** Under current law an employer may permit employees to reimburse expenses from an FSA incurred during a 2 ½ month grace period following the end of the plan year. Previously, this rule posed significant obstacles to individuals seeking to become HSA-eligible as of the start of the following year where their employers chose to offer grace period FSA coverage to employees. Pursuant to the Act, if an individual has a zero balance in his or her FSA on the last day of the FSA plan year, the individual does not fail to be an eligible individual solely because of FSA coverage during the grace period. The Notice makes clear that a cash basis rule applies (see above) for purposes of determining an individual’s account balance as of the close of the plan year.

*Comment: Employers and administrators had been hoping for a definition of “balance” for purposes of this new rule that accounted for incurred but otherwise unreimbursed claims. It was thought that such a definition would be easier to administer and lead to greater utilization of the zero balance rule. It appears that after the 2006 transition period, employees with small FSA or HRA balances remaining after December 31 will be able to make an HSA contribution as of January of the following year only if a Qualified HSA Distribution can be made.*

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