

**Health Savings Accounts:
What You Need to Know about HSAs and Tax-free IRA-HSA Transfers**

IRC § 408(d)(9), Enacted as Part of TRAHCA, December, 2006.

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EXECUTIVE SUMMARY: Effective January 1, 2007, certain individuals can make a one-time tax-free transfer of funds from an IRA to a health savings account (HSA). Specifically, a person who is eligible to contribute to an HSA can, for one year (any year he chooses, but only once), fund his HSA by means of a direct transfer from his IRA instead of by writing a check from his taxable checking account. Since the new type of permitted transfer does not increase the amount that can be contributed to the HSA; and since HSA contributions are *already* deductible in determining adjusted gross income; this new type of IRA distribution will provide a benefit to only a few people. The bottom line: HSAs are great, and you should have one if you're eligible. However, almost everyone should fund the HSA from a taxable account, NOT by transferring funds from an IRA.

RESOURCES: IRC §223, § 408(d)(9); IRS Notice 2004-2, 2004-2 I.R.B. 269 (“Health Savings Accounts”); IRS Notice 2004-50, 2004-33 I.R.B. 196 (“Health Savings Accounts: Additional Qs&As”); Rev. Proc. 2006-53, 2006-48 I.R.B. 996.

BACKGROUND: In 2003, Congress created “Health Savings Accounts” under IRC § 223 to encourage people to become more involved in controlling the cost of health care. The idea is that, rather than “from dollar one” health care coverage (which divorces the consumer/insured from having to worry about how much his health care costs), the consumer would have a high deductible health care plan, so he would have to pay more of the medical care costs out of his own pocket. The consumer’s reward for signing up for a high deductible health plan (HDHP) is the HSA: a tax-free bank account he can use to pay his future medical expenses.

HSAs did not prove very popular, so Congress (in the Tax Relief and Health Care Act of 2006, “TRAHCA”) made several changes designed to encourage more consumers to adopt HSAs. One change was to eliminate the requirement that the annual HSA contribution not exceed the amount of the deductible on the individual’s health insurance policy; see Question #4(A), below. A second change allows people who become eligible late in the year to contribute the full annual dollar limit amount rather than a prorated amount; see Question #4(F).

The third TRAHCA change is a new provision allowing one-time funding of the annual HSA contribution via a tax-free IRA transfer called a “qualified health savings account funding distribution” (QHSAFD). § 408(d)(9). To understand the new QHSAFDs, you first need to understand Health Savings Accounts.

NOTE: An HSA may be established by an employer for its employees, or may be established by an individual for him/herself. An employer establishing an HSA will typically have guidance from the insurance provider and/or HSA provider it has selected to operate the plan. This paper accordingly focuses primarily on an individual or self-employed person who is establishing an HSA for him/herself.

1. What is an HSA? What is the tax treatment of contributions to an HSA?

An HSA is a tax-free savings/investment account. An HSA has several similarities to an IRA, for example: There must be a bank custodian. § 223(d)(1)(B). Its funds cannot be invested in life insurance. § 223(d)(1)(C). Accumulations inside the account are tax-free (except for the tax on UBTI). § 223(e)(1). Tax-free rollovers are allowed between HSAs subject to a 60-day time deadline and once-per-year limit. § 223(f)(5). Like an IRA, an HSA can accept (aside from rollover contributions) only cash contributions up to a certain fixed-dollar amount (see Question #4). § 223(d)(1)(A). And, like an IRA, an HSA is automatically terminated (deemed distributed) if the account is pledged as security or in case of a prohibited transaction. § 223(e)(2).

There is a major difference, however: Distributions from an HSA are *tax-free* if used to pay medical expenses. § 223(f)(1). This provides a sharp contrast to retirement plans. With a Roth IRA, distributions are tax-free, but the owner has to pay income tax on the money going *into* the Roth IRA. With a traditional retirement plan, the owner usually gets a tax deduction for money he puts into the plan—but then must pay income tax on distribution *from* the plan. Only an HSA combines *tax-deductible contributions* with *tax-free distributions*!

Contributions to an HSA are deductible from gross income in arriving at adjusted gross income. § 223(a); Notice 2004-2, A-17. They are not itemized deductions; thus the deduction for an HSA contribution is not subject to the reduction of itemized deductions that applies to high-income taxpayers under § 68, and may be taken in addition to the standard deduction. Notice 2004-2, A-17. HSA contributions are deductible for the alternative minimum tax as well as for the regular income tax. § 56. HSA contributions are excluded from modified adjusted gross income for purposes of determining how much of a person’s Social Security benefits are taxable under § 86. § 86(b)(2).

2. Who can have an HSA?

To be eligible to contribute to an HSA, a person must meet the following requirements:

- ◆ The person must have a “high deductible health plan” (HDHP). See Question #3. Specifically, an individual is eligible to contribute to an HSA for a particular month if he is “covered under a high deductible health plan as of the 1st day of such month.” § 223(c)(1)(A)(i).
- ◆ He/she must NOT be covered by any other health plan that (i) provides the same type of coverage as the HDHP but (ii) is not an HDHP (including Medicare; see Question #10). § 223(c)(1)(A)(ii). In applying this test, certain plans are disregarded, such as accident, disability, dental, and long-term care insurance; workers’ comp and liability-type coverage; and policies covering specific illnesses or paying a per diem rate for hospitalization. A person can have those types of policies and *still* qualify for an HSA if he owns the required HDHP. § 223(c)(1)(B).
- ◆ He/she must not be eligible to be claimed as a dependent on another person’s tax return. § 223(b)(6); Notice 2004-2, A-2.

A person who owns an HDHP is not obligated to open or contribute to an HSA; the HSA is a benefit you are entitled to if you have the right kind of health coverage, but whether you bother to open one, and how much you contribute to it (up to the stated maximum) are up to you.

3. What is an HDHP?

An HDHP is a health plan with an annual deductible of no less than a certain amount; see § 223(c)(2)(A)(i), (B), for full details. Originally, that amount was \$1,000 (or \$2,000 for a family coverage policy); see Table below for current values. Preventive care may be covered without regard to the deductible. § 223(c)(2)(C).

Fearing that people would be under insured, Congress also decreed a *maximum* deductible, as well as a minimum deductible, that the “high deductible” health care policy must have: Under an HDHP, the consumer’s maximum annual out-of-pocket (i.e. uninsured) cost for medical expenses could be (including the deductible) no more than \$5,000 (as of 2003) for self-only coverage or \$10,000 for family coverage. § 223(c)(2)(A)(ii). After he has spent this amount the consumer is right back in the position of not caring what is spent on his health care, because the insurance company is again footing the bill! Thus does Congress undermine its own strategy.

These minimum deductible and maximum out-of-pocket numbers are subject to inflation adjustments. § 223(g). The current values are:

Table 1: What a HDHP looks like in 2007

<u>Year</u>	<u>Minimum Deductible</u>	<u>Maximum Out-of-pocket</u>	<u>Reference</u>
2007	\$1,050 self-only \$2,100 family	\$5,500 self-only \$11,000 family	Rev. Proc. 2006-53

4. How much may be contributed to an HSA, when?

Like IRAs, HSAs are defined by the maximum that may be contributed to the account. The maximum contribution is determined on both an annual and a monthly basis. For coordination of these limits with contributions to an Archer Medical Savings Account, see § 223(b)(4).

A. Annual maximum

With inflation adjustments, the basic annual maximum HSA contribution is up to \$2,850 as of 2007 (for an individual whose HDHP provides self-only coverage) or \$5,650 (for an individual with a family coverage HDHP). § 223(b)(2); Rev. Proc. 2006-53, sec. 3.24.

The maximum contribution for an individual who has attained age 55 by the end of the year is (for 2007) \$800 more than the above limits, i.e., \$3,650 if his HDHP provides self-only coverage or \$6,450 if the HDHP provides family coverage. § 223(b)(3). This addition to the maximum annual contribution for someone 55 or older will be \$900 for 2008, \$1,000 for 2009 and later years.

Unlike IRA contributions, the contribution limit is not dependent on the amount or existence of the person’s compensation income.

The over-55 extra contribution amount is the same regardless of whether the individual’s HDHP provides self-only or family coverage. Thus, if a husband and wife who are both over 55

want to maximize their HSA contributions, each spouse would have to obtain a self-only policy; this would give them a maximum HSA contribution of \$7,300 (2 X \$3,650). If instead one of them obtains a family coverage HDHP the maximum HSA contribution will be only \$6,450 between them.

Note: A married couple can double up on “self-only” coverage, but they can’t double up on the family coverage. If either spouse has a family coverage HDHP, then they are treated as having only one family coverage HDHP between them, and no self-only coverage; in that case, the maximum HSA contribution is divided between them equally or as they may otherwise agree. § 223(b)(5).

Prior to TRAHCA the annual contribution limit to an HSA was the specified dollar amount, *or, if less, the amount of the deductible under the individual’s HDHP*. TRAHCA eliminated the second limitation, so now **every eligible individual’s maximum HSA contribution is the applicable dollar limit, regardless of the amount of the deductible under his HDHP**. This is a major improvement and should spur greater HSA adoption. Most people tend to choose the lowest possible deductible on their health plans, and an annual HSA contribution limit of \$1,100 was too anemic to interest many people. Now a person can choose the lowest possible “high deductible” and still contribute the full dollar maximum to his HSA.

B. Monthly maximum

The maximum monthly contribution to an HSA is, for each month in which the individual is HSA-eligible, 1/12th of the individual’s annual maximum that applies for that particular calendar year. Both the “basic” dollar limit and the “over-age-55-add-on” amount are prorated monthly. Notice 2004-2, A-14. Many HSAs will be funded through monthly contributions made by payroll deductions; however, lump sum funding is also possible. See C and D below.

C. Post-funding

You are not required to fund the HSA on a monthly basis. You can contribute in arrears; for example, an HSA owner could pay his entire contribution for the calendar year in December. §223(d)(1)(A)(ii). You can even make the contribution *after* the end of the calendar year, by the due date (without extensions) of your tax return. § 223(d)(4)(B); Notice 2004-2, A-21.

D. Pre-funding

The entire year’s HSA contribution can be made at any time during the year, even before it has “accrued.” For example, the individual can contribute the entire year’s contribution in January. Note that if the individual, having made an advance contribution early in the year, ceases to be HSA-eligible at some later time during the year, he will have made an excess contribution, which he will have to withdraw from the plan (with interest) to avoid a penalty; see Question #5.

The contribution may not be made *before* the calendar year for which it applies. Notice 2004-2, A-21.

E. Which is better: Monthly, quarterly, or annual funding?

Since investment accumulations inside the HSA are tax-free, it would appear advantageous to send in the full year's contribution as early as possible, to start earning tax-free interest as soon as possible. The risk of doing so is that, if the person then ceases to be HSA-eligible during the year, he will have made an excess contribution that must be returned (with its income) to avoid the six percent penalty; see Question #5.

F. If you do not become HSA-eligible until after the beginning of the year

Prior to TRAHCA, an individual who became HSA-eligible after the beginning of the year had to prorate his maximum annual contribution down to reflect the partial-year coverage. Now, an individual who becomes HSA-eligible at any time during the taxable year can contribute the applicable annual dollar maximum, even though he was not HSA-eligible for the entire year, *provided* he is HSA-eligible for the last month of the year. § 223(b)(8)(A).

Todd Example: Todd, age 56, acquires a family-coverage HDHP for the first time in November 2007, and does not own any health plan that is not an HDHP. He remains HSA-eligible through December 2007. His maximum contribution to an HSA for 2007 is \$3,650.

However, this new provision comes with a price tag: If an individual takes advantage of this provision to “back fund” for months when he was not HSA-eligible, then he must remain HSA-eligible for the entire calendar year *following* the calendar year for which he made the permitted “extra” HSA contribution. If he ceases to be HSA-eligible during this “testing period,” the extra contribution is included in his gross income for the calendar year in which he first ceases to be eligible, AND is subject to a 10 percent penalty! § 223(b)(8)(B).

Every Penalty is a Little Different

Note: Unlike the six percent penalty for making an excess HSA contribution (see Question #5), this 10 percent penalty for losing HSA eligibility prior to the end of the calendar year after the year in which you took advantage of the increased funding limit for partial-year participation cannot be eliminated by distributing some amount of money out of the HSA to “correct” the extra contribution...because this is not an “excess” (i.e., nonpermitted) contribution, it’s a special larger-than-usual *permitted* contribution!

In “Todd’s” case, the normal 2007 annual maximum HSA contribution for a 56-year-old with a family-coverage HDHP is \$6,450. Because he did not become HSA-eligible until November, Todd’s HSA maximum contribution should be only \$1,075 (\$6,450 divided by 12 months, times two months of eligibility). Instead, because of the TRAHCA change, he is permitted to contribute the full \$6,450 to an HSA for 2007. However, if he contributes more than \$1,075 for 2007, then ceases to be HSA-eligible at any time before the end of 2008, his 2008 gross income will include the “extra” contribution he made (total 2007 contribution minus \$1,075)—and he will owe a penalty of 10 percent of such “extra” amount! (The gross income-plus-penalty punishment will not apply if Todd ceased to be HSA-eligible in 2008 due to death or disability.)

5. What happens if you contribute more than the maximum permitted?

An excess contribution is a contribution (other than a permitted rollover contribution) in excess of the amount that is deductible. § 223(f)(3)(B). There is a six percent excise tax on excess HSA contributions. The excise tax does not apply if the excess contribution, and the income attributable to the excess contribution are distributed to the HSA owner by the extended due date of his/her tax return for the year the excess contribution occurred. The returned contribution is not taxable, but the “income” portion of this corrective distribution is taxable. § 223(f)(3)(A), Notice 2004-2, A-22.

The penalty for an excess HSA contribution can arise if you prefund your HSA with the maximum deductible limit for the entire year, then cease to be HSA-eligible at some time during the year; see Question #4(D). Other reasons it could arise are if you contribute when you are not eligible, or if you just plain old put too much money in the account by mistake.

6. How are HSA distributions taxed?

HSA distributions are excludible from gross income to the extent used to pay qualified uninsured medical expenses of the HSA owner and/or his/her spouse and/or his/her dependents. § 223(f)(1), (2). Note that in contrast to an IRA there is no age restriction: This tax-free use of the HSA funds is permitted even if the owner, spouse, and/or dependents are under age 59½. However, a medical expense that is paid tax-free from an HSA cannot also be deducted as a medical expense under § 213. Notice 2004-2, A-26.

Here are the rules regarding qualified medical expenses:

A. For definition of qualified medical expenses, see § 223(d)(2), and Rev. Rul. 2003-102, 2003-38 I.R.B. 559. Notice 2004-2, A-26.

B. The expenses must be uninsured. § 223(d)(2)(A).

C. The expenses must be incurred after the HDHP becomes effective; the HSA cannot be used to pay pre-existing medical bills. Notice 2004-2, A-26.

D. Qualified medical expenses include qualified long-term care coverage, COBRA health care continuation coverage, and health care coverage while an individual is receiving unemployment compensation; Medicare Part A or B premiums, Medicare HMO, and (for individuals over age 65) the employee share of premiums for employer-sponsored health insurance. Other health insurance premiums, including “Medigap” policies, are NOT qualified medical expenses. § 223(d)(2)(B), (C); Notice 2004-2, A-27.

Corrective distributions (see Question #5) are taxable only to the extent of the “income” included in the distribution. See Notice 2004-50, A-37, for exclusion from income of certain HSA distributions that resulted from a “mistake of fact due to reasonable cause,” if repaid to the HSA.

Distributions that are neither corrective distributions as described in Question #5, nor “mistaken” distributions as described in Notice 2004-50, A-37, nor used for qualified medical expenses are included in the owner’s gross income. §223(f)(2). In addition, any such “other”

distribution is subject to an additional 10 percent tax, UNLESS it is made after the owner either dies, becomes disabled within the meaning of §72(m)(7), or attains “the age specified in section 1811 of the Social Security Act.” § 223(f)(4). According to the IRS, this age is 65. Notice 2004-2, A-25.

7. What happens to the HSA when the owner dies?

The HSA can be paid to a “designated beneficiary” on the death of the account holder or to the account holder’s estate. Here we come to some very intricate provisions in the Code:

- A. **Spouse.** If the HSA is paid to the account holder’s spouse as designated beneficiary, the inherited HSA becomes the surviving spouse’s own HSA. § 223(f)(8)(A). He/she does not include this in income because he/she simply takes it over as account owner (and correspondingly does not get a § 691(a)(1) “IRD” deduction). § 223(f)(8)(B)(ii).
- B. **Owner’s estate.** If the HSA is payable at the owner’s death to the owner’s estate, it ceases to be an HSA “as of the date of death,” and the fair market value of the account as of such date is included in the decedent’s gross income for his last taxable year. There is no IRD deduction to anyone, nor any special adjustment for medical expenses paid after death (see “C”). § 223(f)(8)(B).
- C. **Other beneficiary.** If the HSA is payable at the owner’s death to a person other than the owner’s estate or surviving spouse, it ceases to be an HSA “as of the date of death,” and the fair market value of the account as of such date (minus an adjustment) is included in such person’s gross income for the taxable year that includes the date of death. The adjustment: The amount includible in such person’s gross income in this case is reduced by any qualified medical expenses incurred by the decedent before death and “paid by such person within 1 year after” the date of death. Such person does get an IRD deduction for whatever amount is included in his/her gross income. § 223(f)(8)(B), Notice 2004-2, A-31.

4. What is a qualified health savings account funding distribution (QHSAFD)?

Now we know what a health savings account is and how to get one in the “normal” way, i.e., by making cash deposits to the account in amounts up to the stated maximum. That brings us to the other, brand-new, way to fund a health savings account: by tax-free transfer from an individual retirement account (IRA).

New § 408(d)(9), added to the Code by TRAHCA 2006, effective beginning in 2007, allows a person who is HSA-eligible to transfer funds, one-time only, from his IRA to his HSA. A distribution that meets the requirements of § 408(d)(9) is called a “qualified health savings account funding distribution” (QHSAFD) and is excluded from the IRA owner’s income.

A. Which plans can QHSAFDs come from?

Like qualified charitable contributions, QHSAFDs may be made ONLY from IRAs, not from any other type of retirement plan, and NOT from a SEP-IRA (§ 408(k)) or SIMPLE (§ 408(p)). The transfer must be made DIRECTLY from the IRA to the HSA. § 408(d)(9)(B).

B. How much can be transferred?

The most that can be transferred from the IRA to the HSA is the maximum amount that the individual could contribute at that time to the HSA. § 408(d)(9)(C). Thus, the QHSAFD does NOT increase the amount an individual can stuff into an HSA; rather, it's just an alternative method of funding the amount the individual can place in the HSA.

C. What's the price tag?

If an individual uses the QHSAFD, then he must remain HSA-eligible for 12 months following the month in which the QHSAFD occurs (the “testing period”). § 408(d)(9)(D). For example, if an individual makes a QHSAFD transfer from his IRA to his HSA in May 2007, he must of course be HSA-eligible in that month, and he must remain HSA-eligible for the 12 following months (June 2007–May 2008). If he loses his HSA eligibility during those months (for example by dropping his HDHP plan, or by enrolling in a forbidden “low deductible” health plan), then the *entire amount* (not a prorated amount) of the QHSAFD is included in his gross income for the taxable year in which he first ceased to be HSA-eligible, AND he is liable for a 10 percent penalty on that amount! (These punishments don't apply if he ceases to be HSA-eligible due to death or disability. § 408(d)(9)(D).)

Note: This is NOT the same testing period as the testing period that applies for determining whether you have “earned” the right to “backfund” your HSA when you became HSA-eligible late in the year! Compare Question #4(F).

D. Effect on IRA basis

Like qualified charitable contributions, QHSAFDs are an exception to the “cream-in-the-coffee rule.” See ¶ 2.1.11 of the author's book *Life and Death Planning for Retirement Benefits* (6th ed. 2006; www.ataxplan.com). A QHSAFD is deemed to come entirely from the pre-tax portion of the IRA (rather than proportionately from the pre- and after-tax portions of all of the taxpayer's IRAs, aggregated, like other distributions). § 408(d)(9)(E).

E. Once per customer, and for keeps

The QHSAFD may be done once per lifetime, and is irrevocable. § 408(d)(9)(C)(ii). However, if a person who has done a QHSAFD while he had self-only coverage under his HDHP switches to family coverage later in the same year, see § 408(d)(9)(C)(ii)(II).

9. Why would anyone want to use a QHSAFD?

Most people would never want to use a QHSAFD. Most people should continue to fund their HSAs by depositing checks from their taxable accounts.

A. Short of cash and under age 59½

Apparently, the reason Congress included QHSAFDs in the Tax Code was to allow younger individuals to “jump start” an HSA:

Sean Example: Sean’s employer has just switched Sean and all its other employees to an HDHP, and Sean now has greater responsibilities for paying his and his family’s medical expenses than he previously had. He is short of cash outside his IRA, and expects to face some medical expenses in the near future. He is under age 59½ so he can’t pull money out of the IRA to pay those medical expenses without paying a 10 percent “premature distributions” penalty (because he doesn’t qualify for any of the 13 exceptions to § 72(t)’s penalty on pre-age 59½ distributions). Under the new provision, he can transfer funds, one-time, from the IRA to the HSA, tax-free. This will give him an immediate fund to use to pay his medical bills in a tax-advantaged manner. It will reduce his retirement plan, which is bad, but the alternative for Sean would be going into debt to pay the medical bills, or changing to another job with a more inclusive health insurance policy.

Except for those semi-hardship situations however, in MOST cases clients are better off simply funding the HSA by contributions from their taxable accounts. Even if the client must use the IRA to fund the HSA, it will be better in many such cases to take a cash distribution from the IRA and contribute the cash to the HSA rather than having the money transferred directly to the HSA from the IRA.

Here are some of the considerations:

B. Someone trying to maximize tax-sheltered accounts

If you are trying to maximize the amounts you have in tax-sheltered accounts, then it is better to fund your HSA from your taxable account. This way you maximize the amount in BOTH tax-sheltered accounts rather than depleting your IRA; plus you get a current tax deduction by funding the HSA in the “regular” way rather than by a QHSAFD.

C. Nearing retirement with an overfunded IRA

Oswald Example: Oswald is 62 years old and recently retired. His income is relatively low right now, but his IRA is enormous. He has an HSA and wants to fund it to the max. He could fund it from his checking account (he has plenty of cash), but the income tax deduction isn’t worth much to him because of his low bracket. He’s interested in any way he can find to shrink the IRA in a tax-advantaged manner.

By taking money from his IRA to fund the HSA, Oswald would be converting future taxable income (the IRA) into future tax-free income (the HSA, if it’s used to pay medical expenses), which

is very appealing to someone with an overfunded IRA. HOWEVER, that does not mean Oswald should use a QHSAFD! The disadvantage of using the QHSAFD is that doing so would make Oswald potentially liable for penalties if for some unexpected reason (other than death or disability) he ceases to be HSA-eligible during the testing period (see Question #8(C)).

If Oswald wants to transform his taxable IRA into a tax-free HSA, Oswald can simply take cash out of the IRA, include it in his gross income, then contribute it to the HSA and deduct it from his gross income. He gets the exact same federal income tax effect as with a QHSAFD, but WITHOUT the potential penalty (and the complications). And he can do that EVERY year (until he reaches Medicare age), not just once in a lifetime, as with a QHSAFD.

So the only reason that I can think of why Oswald might be better off using a QHSAFD is if the QHSAFD would somehow produce a better result under his state's income tax; or if he is trying to hide the distribution from his creditors, ex-spouse, or college financial aid officer, so he does not want the distribution to appear on his tax return at all.

D. Short of cash and over age 59½

An HSA-eligible person who wants to fund an HSA, but is short of cash outside of his IRA, might be interested in using his IRA cash to fund the HSA. However, if the person is over age 59½, he/she can simply take a distribution from the IRA, deposit the cash in his/her checking account, then write a check to the HSA. This would have in most cases exactly the same tax effects as a QHSAFD. See Oswald Example at C.

10. How does Medicare coverage affect HSA eligibility?

A person covered by Medicare is NOT eligible to contribute to an HSA. More precisely, an individual's monthly HSA maximum contribution becomes "zero" once he/she becomes entitled to Medicare benefits. § 223(b)(7); Notice 2004-50, A-2.

The reason for this is that Medicare is basically a "low-deductible" health policy, and thus does not fit with the concept of encouraging people to have high deductible health policies. One wonders why the government's own health insurance plan (Medicare) is exactly the opposite of the type it supposedly wants to encourage everyone in America to get.

This means that generally people over age 65 will not be eligible for QHSAFDs, unless for some reason they are not entitled to Medicare. Furthermore, because an individual must remain HSA-eligible for 12 months after the month in which the transfer occurs in order for the IRA-to-HSA transfer to be tax-free, it would appear that the cutoff date for initiating a QHSAFD is the month before the month in which the age 64 birthday occurs.

Dan Example: Dan has an HDHP and is HSA-eligible. He will cease to be HSA-eligible in May 2008, when he will turn 65 and enroll in Medicare. In order to remain HSA-eligible for 12 months following the month in which he executes a QHSAFD, therefore, the last month in which he could effect a QHSAFD would be April 2007. If the transfer occurs in April 2007, he can remain HSA-eligible for the 12 months May 2007–April 2008.

11. How do QHSAFDs compare with Qualified Charitable Distributions?

As a result of 2006 tax law changes, there are now two types of tax-free IRA distributions: qualified charitable distributions (QCDs) and QHSAFDs.

Like the QCDs that were added by the Pension Protection Act of 2006, QHSAFDs allow a certain type of transfer to be made from an IRA directly into another type of tax-exempt entity, bypassing the IRA owner's income tax return. Beyond that the similarity ends.

The requirements for the QHSAFD are more complicated than those for a QCD, yet QHSAFDs offer a smaller potential reward: Whereas the QCD could involve as much as \$200,000 of contributions over two years, the QHSAFD is a one-time transfer of no more than a few thousand dollars.

Also, QCDs are temporary (allowed in 2006–2007 only). Qualified HSA funding distributions are permanent (though any particular individual can use the QHSAFD only once in his lifetime).

Qualified charitable contributions are only for older folks (over 70½). Qualified HSA funding distributions are only for younger folks (under age 64, approximately).

12. Miranda warning: A tale of four penalties

Amazingly enough Congress has managed to cram four different penalties (three 10%, one 6%) into this one tiny little HSA corner of the Tax Code.

Miranda Example: Miranda, age 57, obtains a self-only coverage HDHP and becomes HSA-eligible in December 2007. Taking advantage of TRAHCA's new provisions, she funds her HSA to the dollar maximum for 2007 (\$3,650) in December 2007 using a QHSAFD from her IRA. In January 2008 she contributes the 2008 dollar maximum to her HSA; pretend that this maximum will still be \$3,650, even though it will actually be larger than that due to an increase in the catchup amount and a COLA. In February 2008 she gets a new job where she is covered by a low-deductible health policy that pays all of her medical expenses from dollar one, so she ceases to be HSA-eligible. She cashes out her entire HSA in February 2008; assume the distribution is \$7,300 (i.e., the same amount she contributed). Here are the penalties and income taxes she owes.

- A. **Excess contribution penalty.** She made an excess HSA contribution for 2008 equal to 11/12ths of the 2008 maximum contribution; however, she has avoided the six percent penalty on this by distributing the excess (approximately \$3,345) to herself prior to the due date of her 2008 tax return. See Question #5.
- B. **Penalty on distribution.** She took a distribution from the HSA that was not for medical expenses and that occurred before she died, became disabled, or reached age 65. To the extent the \$7,300 distribution exceeds the corrective distribution (see A), it is includible in her income and subject to a 10 percent penalty. Penalty: 10% X (\$7,300 - \$3,345) = \$395.50. See Question #6.
- C. **Penalty on TRAHCA-permitted backfunding.** She ceased to be HSA-eligible prior to the end of the calendar year (2008) following the year (2007) in which she took

advantage of the increased maximum contribution for certain partial-year HSA participation, so her “extra” 2007 contribution (11/12ths times \$3,650) is subject to an ADDITIONAL 10 percent penalty. $10\% \times 11/12\text{ths} \times \$3,650 = \$334.58$. See Question #4(F).

- D. QHSAFD penalty.** She ceased (for reasons other than death or disability) to be HSA-eligible within 12 calendar months after making a QHSAFD from her IRA, so she is liable for a penalty of 10 percent of the \$3,650 QHSAFD, or \$365. See Question #8(C).

The total of the three penalties is \$1,095.08. As Miranda’s tale shows, it is possible to be liable for multiple penalties under the HSA rules. If Miranda had not refunded the excess 2008 contribution to herself before the due date of her 2008 tax return, she would have owed an additional penalty (6% of the excess contribution), and then had cashed out her account not for medical expenses and before age 65, death or disability, she would have owed all four penalties.

13. What should you tell your clients?

Tell your clients that HSAs are great. HSAs allow them to make a tax-deductible contribution to an account in which they can accumulate funds tax-free, and which will provide a tax-free source of payment for medical bills in retirement (or any time). Tell them to fund their HSAs to the maximum, and remind them that the maximum has increased for most people this year, thanks to TRA8CA’s removing the provisions that, prior to 2007, prevented the insured from contributing more than the policy deductible amount to the HSA and required proration of the maximum for people who became HSA eligible after the beginning of the year.

But tell them to fund their HSAs out of their regular taxable accounts to the maximum extent possible, NOT by using QHSAFDs, unless one of the special considerations discussed above (Question #9) applies.