

Part III - Administrative, Procedural, and Miscellaneous Health Savings Accounts

Notice 2008-51

Section 307 of the Health Opportunity Patient Empowerment Act of 2006 (the Act) added § 408(d)(9) to the Internal Revenue Code. The Act is part of the Tax Relief and Health Care Act of 2006, enacted December 20, 2006, Pub. L. No. 109-432. This notice provides guidance on a qualified HSA funding distribution from an individual's Individual Retirement Account (IRA) or Roth IRA to a Health Savings Account (HSA). The qualified HSA funding distribution is a one-time transfer from an individual's IRA to his or her HSA and generally excluded from gross income and is not subject to the 10 percent additional tax under § 72(t).

BACKGROUND

Eligible individuals

Generally, only eligible individuals (as defined in § 223(c)(1)) may contribute to HSAs. Maximum annual HSA contributions are based on an individual's eligibility, age, and health plan coverage.

General rules on taxation of distributions from IRAs

A distribution from an IRA under § 408 generally is included in gross income. If an IRA owner made nondeductible contributions to the IRA, those contributions are recovered on a pro-rata basis and the distribution is partly included in and partly excluded from gross income under the rules of § 408(d) and § 72(e)(8).

A nonqualified distribution from a Roth IRA under § 408A is included in gross income only to the extent that earnings are distributed. A qualified Roth IRA distribution (as defined in § 408A(d)) is excluded from gross income.

If a distribution from an IRA or Roth IRA is made before the IRA or Roth IRA account owner attains age 59 ½, the distribution also is subject to a 10 percent additional tax under § 72(t) unless an exception applies. These exceptions include distributions made on account of death or disability, and distributions made as part of a series of substantially equal periodic payments for the life expectancy of the IRA holder.

HEALTH OPPORTUNITY PATIENT EMPOWERMENT ACT OF 2006

Tax treatment of qualified HSA funding distributions

Section 408(d)(9) provides, in general, that a qualified HSA funding distribution from an individual's IRA or Roth IRA to that individual's HSA is not included in gross income, if the individual is an eligible individual under § 223(c)(1). Moreover, notwithstanding the pro-rata basis recovery rules under § 72, for purposes of determining the basis in any amount remaining in an IRA or Roth IRA following a qualified HSA funding distribution, the qualified HSA funding distribution is treated as included in gross income to the extent that such amount does not exceed the aggregate amount which would have been so included if there were a total distribution from the IRA or Roth IRA owner's accounts. For example, suppose an individual who has \$200 of basis in an IRA with a fair market value of \$2,000 makes a qualified HSA funding distribution of \$1,500 from the IRA. Immediately after the qualified HSA funding distribution, the individual retains \$200 of basis in an IRA that has a fair market value of \$500.

If a qualified HSA funding distribution from an individual's IRA or Roth IRA exceeds the aggregate amount which would have been included in gross income if there were a total distribution from that individual's IRA or Roth IRA accounts, the individual's basis in the excess amount (i.e., the amount that would have been excluded from gross income in a distribution to which § 408(d)(9) did not apply) does not carry over to the HSA.

A qualified HSA funding distribution is not subject to the 10 percent additional tax under § 72(t). However, if the qualified HSA funding distribution results in a modification of a series of substantially equal periodic payments that, prior to the modification, qualify for the exception to the 10 percent additional tax under § 72(t)(2)(A)(iv), and such modification results in the imposition of the recapture tax under the rules of § 72(t)(4), the recapture tax applies to the payments made before the date of the qualified HSA funding distribution.

The amount contributed to the HSA through a qualified HSA funding distribution is not allowed as a deduction and counts against the individual's maximum annual HSA contribution for the taxable year of the distribution. In addition, the taxability of these distributions is subject to the testing period rules in § 408(d)(9)(D), discussed below.

Qualified HSA funding distribution only from certain types of IRAs

A qualified HSA funding distribution may be made from a traditional IRA under § 408 or a Roth IRA under § 408A, but not from an ongoing SIMPLE IRA under § 408(p) or an ongoing SEP IRA under § 408(k). For this purpose, a SEP IRA or SIMPLE IRA is treated as ongoing if an employer contribution is made for the plan year ending with or

within the IRA owner's taxable year in which the qualified HSA funding distribution would be made.

After the death of an IRA or Roth IRA account owner, a qualified HSA funding distribution may be made from an IRA or Roth IRA maintained for the benefit of an IRA or Roth IRA beneficiary. This distribution will be taken into account in determining whether the required minimum distribution requirements of §§ 408(a)(6), 408(b)(3), and 408A(c)(5) have been satisfied.

Maximum amount of qualified HSA funding distribution

For purposes of § 408(d)(9)(C)(i), a qualified HSA funding distribution from the IRA or Roth IRA of an eligible individual to that individual's HSA must be less than or equal to the IRA or Roth IRA account owner's maximum annual HSA contribution. The maximum annual HSA contribution is based on (1) the individual's age as of the end of the taxable year and (2) the individual's type of high deductible health plan (HDHP) coverage (self-only or family HDHP coverage) at the time of the distribution. For example, in 2008, an IRA owner who is an eligible individual with family HDHP coverage at the time of the distribution and who is age 55 or over by the end of the year is allowed a qualified HSA funding distribution of \$5,800, plus the \$900 catch-up contribution. An IRA or Roth IRA owner who is an eligible individual with self-only HDHP coverage, and who is under age 55 as of the end of the taxable year, is allowed a qualified HSA funding distribution of \$2,900 for 2008.

One-time qualified HSA funding distribution

Generally, only one qualified HSA funding distribution is allowed during the lifetime of an individual. If, however, the distribution occurs when the individual has self-

only HDHP coverage, and later in the same taxable year the individual has family HDHP coverage, the individual is allowed a second qualified HSA funding distribution in that taxable year. Both distributions count against the individual's maximum HSA contribution for that taxable year. The distributions must be from an IRA or Roth IRA to an HSA owned by the individual who owns the IRA or Roth IRA or, in the case of an inherited IRA, for whom the IRA or Roth IRA is maintained (i.e., a qualified HSA funding distribution cannot be made to an HSA owned by any other person, including the individual's spouse). IRA or Roth IRA owners are not required to make the maximum qualified HSA funding distribution or to make any qualified HSA funding distribution.

If an individual owns two or more IRAs, and wants to use amounts in multiple IRAs to make a qualified HSA funding distribution, the individual must first make an IRA-to-IRA transfer of the amounts to be distributed into a single IRA, and then make the one-time qualified HSA funding distribution from that IRA.

No deemed distribution date

A qualified HSA funding distribution relates to the taxable year in which the distribution is actually made. The rules in § 223(d)(4)(B) and § 219(f)(3) (contributions made before the deadline for filing the individual's federal income tax return are deemed to be made on the last day of the preceding taxable year) do not apply to qualified HSA funding distributions.

Procedures for making the transfer from an IRA to an HSA

An individual must be an eligible individual (as defined in § 223(c)(1)) at the time of the qualified HSA funding distribution. The distribution must be a direct transfer from an IRA or Roth IRA to an HSA. For example, if a check from an IRA or Roth IRA is

made payable to an HSA trustee or custodian and delivered by the IRA or Roth IRA account owner to the HSA trustee or custodian, the payment to the HSA will be considered a direct payment by the IRA or Roth IRA trustee, custodian or issuer to the HSA for purposes of § 408(d)(9).

Testing period rules

If a qualified HSA funding distribution is made from the individual's IRA or Roth IRA to the individual's HSA under § 408(d)(9) and the individual remains an eligible individual during the entire testing period, the amount of the qualified HSA funding distribution is excluded from the individual's gross income and the 10 percent additional tax under § 408(d)(9)(D) does not apply. The testing period begins with the month in which the qualified HSA funding distribution is contributed to the HSA and ends on the last day of the 12th month following that month. Each qualified HSA funding distribution allowed in § 408(d)(9)(C)(ii)(II) has a separate testing period. For testing period purposes, an eligible individual who changes from family HDHP coverage to self-only HDHP coverage during the testing period remains an eligible individual. If at any time during the testing period the individual ceases to meet all requirements to be an eligible individual, the amount of the qualified HSA funding distribution is included in the individual's gross income. The qualified HSA funding distribution is included in gross income in the taxable year of the individual in which the individual first fails to be an eligible individual. This amount is subject to 10 percent additional tax (unless the failure is due to disability, as defined in § 72(m)(7), or death). See § 408(d)(9)(D). Earnings on the amount of the qualified HSA funding distribution are not included in gross income. Amounts included in the IRA or Roth IRA owner's gross income under §

408(d)(9)(D) are not also included in gross income under § 408(d)(1) or (2), nor do the § 72 rules apply (including the additional tax under § 72(t)).

No interaction between testing periods

Section 223(b)(8)(B) provides generally that if an individual fails to remain an eligible individual during the § 223(b)(8) testing period, an amount is included in the individual's gross income (computed by subtracting the sum of the monthly contribution limits that the individual would otherwise have been entitled to under § 223(b)(1) and (2) from the amount actually contributed). The testing period rules in § 223(b)(8)(B) do not apply to amounts contributed to an HSA through a qualified HSA funding distribution. Thus, if an individual remains an eligible individual during the entire § 408(d)(9) testing period, then no amount of the qualified HSA funding distribution is included in income and the 10 percent additional tax under § 223(b)(8)(B) does not apply.

Application of § 223(b)(8)(B) testing period to contributions which are not qualified HSA funding distributions

If an HSA account beneficiary's contributions to his or her HSA in a taxable year include both a qualified HSA funding distribution (or distributions) and other contributions subject to § 223(b)(8), the § 408(d)(9)(D) testing period rules apply to qualified HSA funding distribution (or distributions) and the § 223(b)(8)(B) testing period rules apply to the other contributions. If the individual fails to remain an eligible individual during the § 223(b)(8)(B) testing period, but does remain a qualified individual during the § 408(d)(9)(D) testing period, the amount included in the individual's gross income is the lesser of:

(1) the amount that would otherwise be included under the § 223(b)(8)(B) rules;

or

(2) the amount of contributions to the HSA for the taxable year other than the amount contributed through qualified HSA funding distributions.

HSA distributions not used for qualified medical expenses

An HSA distribution not used for qualified medical expenses (as defined in § 223(d)(2)) is included in gross income under § 223(f)(2) and subject to the 10 percent additional tax under § 223(f)(4) (with certain exceptions), regardless of whether the amount contributed to the HSA under the qualified HSA funding distribution is included in the account beneficiary's income and subject to the additional tax under § 408(d)(9)(D). See Notice 2007-22, 2007-10 I.R.B. 670, regarding the consequences of distributions from HSAs.

EXAMPLES

The following examples illustrate these rules. It is assumed in the examples that no previous qualified HSA funding distributions have been made by the individual, and that all distributions are from IRAs and are otherwise included in the IRA owner's gross income. None of the IRAs are ongoing SEP IRAs described in § 408(k), or ongoing SIMPLE IRAs described in § 408(p). For purposes of § 223(f)(4) and § 408(d)(9)(D)(ii), none of the IRA owners or HSA account beneficiaries are disabled. None of the exceptions to the 10 percent tax under § 72(t) apply.

Example 1. Individual A, age 45, enrolls in family HDHP coverage on January 1, 2008, is otherwise an eligible individual (as defined in § 223(c)(1)) as of that date and through December 31, 2009. A's maximum annual HSA contribution for 2008 is \$5,800. A owns an IRA with a balance of \$2,000. A direct trustee-to-trustee transfer of \$2,000 is made from A's IRA trustee to A's HSA trustee on April 2, 2008.

The \$2,000 distribution is a qualified HSA funding distribution, and accordingly is not included in A's gross income and is not subject to the additional tax under § 72(t). A's testing period with respect to the qualified HSA funding distribution begins in April 2008 and ends on April 30, 2009. After the qualified HSA funding distribution of \$2,000, \$3,800 of A's 2008 HSA maximum annual contribution remains.

Example 2. Same facts as Example 1, except that A ceases to be an eligible individual on January 1, 2009. Under § 408(d)(9)(D), in 2009 A must include \$2,000 in gross income, the amount of the qualified HSA funding distribution, plus an additional tax of \$200 (10 percent of the amount included in income).

Example 3. Individual B, age 57, enrolls in self-only HDHP coverage effective January 1, 2008, is otherwise an eligible individual as of that date and through December 31, 2009. B's maximum annual HSA contribution for 2008 is \$3,800 (\$2,900 plus the \$900 catch-up contribution). B owns an IRA with a balance of \$13,550. A direct trustee-to-trustee transfer of \$3,800 is made from B's IRA trustee to B's HSA trustee on June 4, 2008.

The \$3,800 distribution is a qualified HSA funding distribution. The distribution from B's IRA is not included in B's gross income and is not subject to the additional tax under § 72(t). The qualified HSA funding distribution of \$3,800 equals B's 2008 maximum annual HSA contribution. B's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009.

Example 4. Individual C, age 38, enrolls in self-only HDHP coverage on January 1, 2008, is otherwise an eligible individual on January 1, and remains an eligible individual through December 31, 2009. C owns an IRA with a balance of \$12,550. A qualified HSA funding distribution of \$2,800 is made from C's IRA trustee directly to C's HSA trustee on June 4, 2008.

On August 1, C enrolls in family HDHP coverage. A transfer of \$3,000 is made from C's IRA trustee directly to C's HSA trustee on August 15, 2008.

The \$2,800 and \$3,000 distributions are qualified HSA funding distributions. The distributions from the IRA are not included in C's gross income and are not subject to the additional tax under § 72(t). The qualified HSA funding distributions of \$5,800 (\$2,800 + \$3,000) equal C's 2008 maximum annual HSA contribution. C's testing period for the first qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009 and the testing period for the second qualified HSA funding distribution begins in August 2008 and ends on August 31, 2009.

Example 5. Individual D, age 43, enrolls in family HDHP coverage on January 1, 2008, is otherwise an eligible individual on January 1, and remains an eligible individual through December 31, 2009. D owns an IRA with a balance of \$17,500. A qualified HSA funding distribution of \$5,800 is made from D's IRA trustee directly to D's HSA trustee on March 18, 2008.

On June 1, D changes from family HDHP coverage to self-only HDHP coverage. The \$5,800 distribution from the IRA is not included in D's gross income and is not subject to the additional tax under § 72(t). The qualified HSA funding distribution of \$5,800 equals D's maximum annual HSA contribution at the time the transfer occurred. D's testing period begins in March 2008 and ends on March 31, 2009.

Example 6. Individual E, age 50, begins family HDHP coverage and is first an eligible individual on June 1, 2008. E owns an IRA with a balance of \$20,000. A direct trustee-to-trustee transfer of \$3,500 is made from E's IRA trustee to E's HSA trustee on June 4, 2008. On June 4, 2008 E also contributes \$2,300 in cash to his HSA for a total contribution of \$5,800. On July 1, 2009, E ceases to be an eligible individual.

The \$3,500 distribution is a qualified HSA funding distribution, is not included in E's gross income, and is not subject to the additional tax under § 72(t). E's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009. E remains an eligible individual during the qualified HSA funding distribution testing period. No amount of the \$3,500 distribution is included in E's gross income.

The testing period for the \$2,300 contribution begins in December 2008 and ends on December 31, 2009. E's full contribution limit under § 223(b)(8) for 2008 is \$5,800. E's sum of the monthly contribution limits is \$3,383 ($7/12 \times \$5,800$). E's maximum annual contribution for 2008 is \$5,800, the greater of \$5,800 or \$3,383.

The amount included in E's gross income and subject to the 10 percent additional tax under § 223(b)(8)(B) in 2009 is \$2,417 ($\$5,800 - \$3,383$). The cash contribution to E's HSA is \$2,300. The amount included in E's gross income and subject to additional tax is \$2,300, the lesser of \$2,417 or \$2,300.

Example 7. Same facts as Example 6, except that the distribution from E's IRA to E's HSA is \$1,000 and E contributes \$4,800 in cash for a total HSA contribution of \$5,800 in 2008.

E remains an eligible individual during the qualified HSA funding distribution testing period. No amount of the \$1,000 distribution is included in E's gross income.

E's full contribution limit under § 223(b)(8) for 2008 is \$5,800. E's sum of the monthly contribution limits is \$3,383 ($7/12 \times \$5,800$). E's maximum annual contribution limit for 2008 is \$5,800, the greater of \$5,800 or \$3,383. The amount included in E's gross income and subject to the 10 percent additional tax under § 223(b)(8)(B) is \$2,417 ($\$5,800 - \$3,383$). The cash contribution to E's HSA is \$4,800. The amount included in E's gross income and subject to the additional tax in 2009 is \$2,417, the lesser of \$2,417 or \$4,800.

Example 8. Same facts as Example 6, except that E ceases to be an eligible individual on May 1, 2009.

The \$3,500 distribution is a qualified HSA funding distribution, is not included in E's gross income in the year of the distribution, and is not subject to the additional tax under § 72(t). E's testing period with respect to the qualified HSA funding distribution begins in June 2008 and ends on June 30, 2009. E ceases to be an eligible individual during the qualified HSA funding distribution testing period. The \$3,500 distribution is included in E's gross income. In addition, the 10 percent additional tax (\$350) under § 408(d)(9)(D)(II) applies to the amount.

The testing period for the \$2,300 contribution begins in December 2008 and ends on December 31, 2009. E's full contribution limit under § 223(b)(8) for 2008 is \$5,800. E's sum of the monthly contribution limits is \$3,383 ($7/12 \times \$5,800$). E's maximum annual contribution limit for 2008 is \$5,800, the greater of \$5,800 or \$3,383.

The amount included in E's gross income and subject to the 10 percent additional tax in 2009 under § 223(b)(8) is \$2,417 ($\$5,800 - \$3,383$). The cash contribution to E's HSA is \$2,300. The amount included in E's gross income and subject to additional tax is \$2,300, the lesser of \$2,417 or \$2,300.

Example 9. Individual F, age 47, has family HDHP coverage and is first an eligible individual on January 1, 2008. F's maximum annual HSA contribution for 2008 is \$5,800. F owns an IRA with a balance of \$10,000. A direct trustee-to-trustee transfer of \$10,000 is made from F's IRA trustee to F's HSA trustee on September 26, 2008.

The \$10,000 contribution exceeds F's \$5,800 contribution limit. In 2008, \$4,200 ($\$10,000 - \$5,800$) is included in F's gross income under § 408 as a taxable IRA distribution. The \$4,200 is also subject to additional tax under § 72(t), as well as an excise tax on excess HSA contributions under § 4973.

Example 10. Individual G, age 32, has self-only HDHP coverage and is first an eligible individual on January 1, 2007. G remains an eligible individual through December 31, 2009. G's maximum annual HSA contribution for 2007 is \$2,850 and \$2,900 for 2008. G owns an IRA with a balance of \$4,500. A direct trustee-to-trustee transfer of \$1,000 from G's IRA trustee to G's HSA trustee is made on September 6, 2007.

Another direct trustee-to-trustee transfer of \$1,500 from G's IRA trustee to G's HSA trustee is made on April 28, 2008. G makes no other contributions to his HSA for 2008.

The \$1,000 contribution to G's HSA in September 2007 is a qualified HSA funding distribution, is not included in G's gross income, and is not subject to the additional tax under § 72(t). G's testing period with respect to this contribution begins in September 2007 and ends on September 30, 2008.

The \$1,500 contribution to G's HSA in April 2008 is not a qualified HSA funding distribution, is included in G's gross income for 2008 under § 408 as a taxable IRA distribution, and is subject to the additional tax under § 72(t). However, the \$1,500 contribution to G's HSA is allowed as a deduction under § 223(a) in 2008, because G remains an eligible individual in 2008 and has not otherwise made contributions to the HSA or had contributions on G's behalf made to an HSA in excess of \$1,400 for 2008. No testing period under § 408 applies to the \$1,500 contribution.

REPORTING AND WITHHOLDING

Employers are not responsible for reporting whether an employee remains an eligible individual during the testing period.

A qualified HSA funding distribution is not subject to withholding under § 3405 because an IRA or Roth IRA owner that requests such a distribution is deemed to have elected out of withholding under § 3405(a)(2). For purposes of determining whether a distribution requested by an IRA or Roth IRA owner satisfies the requirements of § 408(d)(9), the IRA or Roth IRA trustee may rely upon reasonable representations made by the account owner.

EFFECTIVE DATE

Sections 408(d)(9) and 223(b)(4)(C), allowing qualified HSA funding distributions from IRAs to HSAs, are effective for taxable years beginning after December 31, 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). For information regarding the rules applicable to IRAs, contact Cathy V. Pastor at (202) 622-6090 (not a toll-free call).