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ALSO IN THIS ISSUE –

Appreciated Guidance on the Special Testing Period Taxes, Page 4

IRS Issues Guidance on HSA Contributions for 2007, 2008 and Later Years, Page 6

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IRS Issues Guidance on IRA/Roth IRA transfers to an HSA

The IRS has recently (June 2008) issued Notice 2008-51 to provide guidance on an IRA accountholder's right to transfer IRA funds tax-free to his or her HSA. As with other recent IRS guidance, there is the expected, the unexpected and the appreciated guidance. The current IRS likes HSAs and, in general, this guidance continues the approach of making it easy for individuals to realize the tax and economic benefits associated with HSAs.

The unexpected is what is most interesting. We will discuss the unexpected first and then discuss the expected.

There were two unexpected rulings.

1. The law as written seems to authorize a transfer of only the "taxable portion" of a traditional IRA or Roth IRA. The non-taxable portion or the "basis" was thought to be ineligible to be transferred to an HSA. The IRS has adopted an approach allowing any traditional IRA and/or Roth IRA funds to be transferred to an HSA, including non-taxable basis. However, if a person chooses to transfer his or her basis from either a traditional IRA and/or Roth IRA, the individual will not be able to carry over this basis to his or her HSA. The IRS has adopted the position that the general HSA distribution rule will be applied even if a person has transferred IRA basis into his or her HSA. Example – an individual transfers $3,000 of nontaxable Roth IRA contributions and then later withdraws the $3,000 from the HSA and uses it for non-medical reasons. The individual will owe income tax on the $3,000 and also owe the 10% tax, if applicable.

2. An inheriting IRA beneficiary has the right to make a tax-free transfer of his or her inherited IRA interest to his or her own HSA. It is certainly not clear that Congress intended to allow a beneficiary to make a tax-free transfer from a decedent's IRA to his or her own HSA, but the IRS has authorized such a transfer in this Notice. And it gets better. When a beneficiary transfers funds from his or her inherited IRA to an HSA, such a transfer will count to satisfy his or her IRA required distribution from the inherited IRA.

The expected rulings.

1. This tax-free transfer (qualified HSA funding distribution) is a type of contribution. However, it is more like a rollover contribution than an annual contribution even though it counts against the annual contribution limit. Therefore, the IRS has concluded that the contribution relates to the tax year in which the transfer is actually made and that a person cannot use the special rule that a contribution is timely if made before the deadline

Continued on page 2

Transfers to an HSA,
Continued from page 1

for filing the individual's federal income tax return because the contribution is deemed made on the last day of the preceding tax year.

2. This tax-free transfer counts against the individual's maximum annual HSA contribution for the tax year of the transfer/distribution. Thus, if the distribution takes place in 2008, then the 2008 contribution limit applies. The fact that this tax-free transfer counts against the contribution limit does not mean that the individual is able to claim a tax deduction for the transfer amount. He or she cannot. To allow a tax deduction, would be to allow a second tax benefit in addition to the tax-free treatment. This Notice makes clear that the maximum contribution amount includes any catch-up amount, if applicable. 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 $6,700 for 2008 ($5,800 plus $900). An IRA owner who is an eligible individual with self-only HDHP coverage, and who is age 55 or over December 31, 2008 is allowed a qualified HSA funding distribution of $3,800 for 2008 ($2,900 + $900).

   The maximum amount which can be transferred tax-free is determined at the time of the transfer and not later in the year. A person who is covered under a HDHP in March of 2008 may transfer from an IRA to an HSA in March the "family" amount even though later in 2008 he switches to a "single" HDHP. The IRS has concluded that there will be no penalty for switching to the "single" coverage. The person is still allowed the benefit of transferring the family amount. See Example 5 as set forth below.

   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.

3. A literal reading of the law is that this type of tax-free transfer may not be made from a SEP-IRA or SIMPLE-IRA to an HSA. As with the tax-free charitable distributions, the IRS played word games and changed the rule to be – a person will be able to take funds from their SEP-IRA or SIMPLE-IRA and transfer them to their HSA as long as such SEP or SIMPLE is not an "on-going" plan. That is, the transfer is permissible as long as the employer has not made an employer contribution for the plan year ending with or within the SEP-IRA or SIMPLE-IRA owner's tax year.

4. The transaction will be tax-free only if it is done by a direct transfer. As with the tax-free charitable distribution which again could be accomplished only by a direct transfer, the IRS has determined that as long as the check is made payable to the HSA custodian or trustee, then the check may be given to the individual who then delivers the check to the HSA custodian or trustee.

5. The general rule is that a person is allowed only one tax-free transfer during his or her lifetime. One means one. Therefore, if a person has two or more IRAs and wants to use amounts in multiple IRAs to make the tax-free transfer, if eligible, the individual must first make an IRA to IRA or Roth IRA to Roth IRA transfer of the amounts to be distributed into a single IRA, and then make the one tax-free transfer. The IRS points out that a person who has both a traditional IRA and a Roth IRA will only be able to do the transfer from one or the other IRA.

Continued on page 3

The Pension Digest

Transfers to an HSA, Continued from page 2

6. There is the one special situation where the law expressly authorizes two tax-free transfers. An individual who makes a tax-free transfer from his traditional IRA or Roth IRA to his HSA while he is covered under a self-only HDHP is permitted a second tax-free transfer if later in the same tax year he acquires family HDHP coverage. Both such transfers will count against the contribution limit for the year. Each such transfer will have its own testing period for recapture tax purposes. Set forth below is IRS Example #4.

   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.

7. A person who has established a substantially equal periodic payment schedule with respect to his or her IRA is eligible to make a tax-free transfer to his or her HSA. The amount transferred will not be taxed and will not be subject to the 10% additional tax. However, a determination will need to be made whether or not the qualified HSA funding distribution results in an impermissible modification. If there is an impermissible modification, then the recapture tax of Code section 72 applies to the previous payments.

   We believe an individual age 58 with a family HDHP who normally received his SEPP distribution of $14,400 in October of each year by having it withdrawn and placed in his checking account could in 2008 instruct that he wanted the $14,400 handled as follows. $6,700 was to be transferred to his HSA and the remaining $7,700 placed in his checking account. In this example, the is no impermissible modification of the SEPP schedule. However, there would be an impermissible modification of the schedule if he instructed to transfer $6,700 to his HSA in addition to his scheduled distribution of $14,400.

8. The traditional or Roth IRA custodian or trustee is allowed to rely upon the instructions of the IRA owner that he or she qualifies to do this tax-free transfer as long as such representations are reasonable. CWF Form #66-HSA obtains this reasonable representation.

   Being a tax-free transfer, the IRS has ruled that the withholding rules do not apply because the IRA accountholder is deemed to have elected out of withholding.

9. The IRS has expressly stated that an employer has no responsibility to report whether an employee remains an eligible individual during a testing period. The IRS is silent as to whether or not the HSA custodian or trustee has any duty to do any special reporting regarding testing periods. One would think not, but it may be that the IRS was not ready to expressly state that an HSA custodian or trustee has no reporting duties with respect to the various testing periods. ◆

Appreciated Guidance on the Special Testing Period Taxes

1. There are special taxes applying to the HSA owner who makes a tax-free transfer from his or her IRA to his or her own HSA, but then is no longer an eligible individual during a testing period. The testing period begins with the month in which the qualified HSA funding distribution is made and ends on the last day of the 12th month following that month. For example, if a person makes the tax-free transfer on September 5, 2007, then the testing period will end on September 30, 2008. The primary reason a person becomes ineligible is because he or she is no longer covered by a HDHP. However, a person could also become ineligible because he or she enrolls in Medicare prior to the expiration of the testing period.

2. The IRS has made clear that the tax-free transfer does not become an excess contribution when the individual is no longer an eligible individual during the testing period. The 6% excess contribution tax does not apply. The individual is not required to or able to withdraw the distribution as an excess contribution.

3. An attempted transfer which for some reason does not qualify as a tax-free transfer may be an excess contribution. The individual will need to take steps to correct this excess contribution or the 6% excise tax will be owed.

4. The standard HSA distribution rules will apply to funds transferred from an IRA to an HSA even if the individual becomes subject to the special testing period taxes. Any withdrawn funds not used to pay qualified medical expenses will be included in the recipient's income and will be subject to the 10% additional tax unless the exception for death or disability applies.

5. There will be some individuals whose annual contribution is comprised of a tax-free transfer portion and another portion comprised of a regular annual HSA contribution under the "full contribution rule." There are two separate testing periods. An individual may become an ineligible individual during one or both periods. The individual in some cases will bear two adverse tax consequences for becoming an ineligible individual during the testing period after having made a regular HSA contribution.

   The amount to be included in a person's income is the lesser of: (1) the amount that otherwise would be included or (2) the amount of the contributions to the HSA for such tax year other than the tax-free transfer amount.

IRS Examples 6-10.

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 for 2009.

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 x $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 for 2009 and subject to the 10% additional tax is $2,300, the lesser of $2,417 or $2,300.

Continued on page 5

Testing Period Taxes, Continued from page 4

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 for 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 x $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 10% 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. (As discussed below E will bear two adverse tax consequences. CWF Note.)

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 for 2009. In addition, the 10 percent additional tax ($350) under §408(d)(9)(D)(II) applies for 2009.

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 x $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. ◆

THE Pension Digest

IRS Issues Guidance on HSA Contributions for 2007, 2008 and Later Years

The HSA tax laws have always defined maximum annual contribution amounts depending upon self-only HDHP coverage or family HDHP coverage. These amounts are adjusted annually for cost of living changes by applying a statutory formula. For 2008, the maximum contribution amount for an HSA eligible person younger than age 55 as of the end of 2008 is $2,900 for self-only HDHP coverage and $5,800 for family HDHP coverage and the maximum contribution amount for an HSA eligible person age 55 or older as of the end of 2008 is $3,800 for self-only HDHP coverage and $6,700 for family HDHP coverage.

A specific individual's maximum annual contribution is the sum of his or her monthly contribution limits determined separately for each month, based on eligibility and health plan coverage as of the first day of the month. Prior to 2007, in order for an individual to determine what his or her maximum annual contribution amount was, the HSA eligible individual had to compare the HDHP's deductible limit against the statutory amounts because the maximum annual contribution was the lesser amount. For 2007 and subsequent years, as long as an eligible individual is covered by a qualifying HDHP, then the statutory maximum annual contribution amount applies regardless of the deductible. The general rule still applies that a person determines his or her annual contribution amount by adding together his or her monthly contribution amounts. However, there is now a very large exception. In 2007 and subsequent years there is a special rule which allows a person to make a full year contribution as long as the individual is covered by an HSA/HDHP as of December 1. This full contribution is permitted even if there is only one month of HDHP coverage. A special penalty tax is assessed if a person does not maintain HDHP coverage during a testing period which ends on December 31 of the following year.

The IRS issued Notice 2008-52 in June of 2008 to discuss and explain these law changes.

An individual's maximum HSA contribution for 2007 and later years is the greater of the following:

1. The sum of the individual's monthly contribution limits determined separately for each month, based on eligibility and health plan coverage as of the first day of the month plus the sum of the monthly catch-up amounts, or
2. The maximum annual contribution is based on the individual's HDHP coverage (self-only or family) on December 1 plus catch-up contributions, if applicable. The individual is treated as if he or she had such coverage for the full year. Actually, the maximum annual contribution is based on the individual's HDHP coverage as of the first day of the last month of the individual's tax year. Since most taxpayers have a calendar year tax year, the determination date is December 1. This special rule is called the full contribution rule. Note that the full contribution rule applies only if the individual has HDHP coverage as of December 1. This full contribution rule applies without regard to whether the individual was an eligible individual for the entire year, had HDHP coverage for the entire year, or had disqualifying non-HDHP coverage for part of the year.

A simpler way to state the rule – the full contribution rule will always determine the maximum contribution unless it is unavailable. In such case the monthly limitation rules must be applied.

An individual may establish an HSA at any time on or after the date the individual becomes HSA eligible. The individual may make one or more contributions at any time prior to the time (without extension) for filing the individual's federal income tax return. Once eligible, the individual is permitted to make the maximum contribution, but he or she is responsible to determine if there has been an excess contribution.

A testing period applies for purposes of the full contribution rule. The testing period begins on the first day of the last month of the individual's tax year and ends on the last day of the 12th month following that month. Thus, for a calendar year end taxpayer, the testing period is from December 1 of the current year to December 31 of the following year. For 2007 contributions made pursuant to the

Continued on page 7

HSA Contributions, Continued from page 6

full contribution rule by a person who has a calendar year tax year, the testing period is December 1, 2007 to December 31 2008. For 2008 contributions made pursuant to the full contribution rule by a person who has a calendar year tax year, the testing period is December 1, 2008 to December 31, 2009.

There is an adverse tax consequence if an individual who has used the full contribution rule to make his or her HSA contribution ceases to be an eligible individual for any reason at any time during the testing period. He or she is required to include a certain amount in his income, and he or she will have to pay a 10% penalty tax. This is a new 10% penalty tax. This 10% tax is not owed when the failure during the testing period occurred on account of a death or disability. The amount required to be included in income is the full contribution amount as reduced by the sum of the monthly contribution limits to which the individual was entitled under the monthly limit rules. There is no requirement for the individual to withdraw any portion of the contribution made using the full contribution rule even though the individual ceased to be eligible during the testing period. There also is no special rule allowing an individual to withdraw any portion of the contribution made using the full contribution rule even though the individual ceased to be eligible during the testing period. The standard HSA distribution rules still apply. That is, any HSA distribution not used for qualified medical expenses, is included in the individual's gross income and is subject to the 10% additional tax if the recipient is younger than age 65 unless the exceptions for death or disability apply. There is no excess contribution. Withdrawing any portion of the contribution does not reduce the amount to be included in income or the 10% tax. This 10% tax applies regardless of the age of the HSA account owner even if he or she is older than age 65.

The adverse tax consequences arise when an individual ceases to be an eligible individual during the testing period. There is no requirement that the individual maintain the same level of HDHP Coverage during the testing period the individual may switch from family HDHP coverage to self-only HDHP coverage without the imposition of the adverse tax consequences.

CWF Examples

Example 1. David, age 51, is first covered under a family HDHP on December 1, 2008 and is otherwise eligible. He was HSA ineligible for the first 11 months. His maximum contribution is $5,800 since the $5,800 is greater than the sum of the monthly limitations, $483.33 (1/12 of $5,800).

Example #2. Rosa, age 36, becomes covered by a family HDHP on January 1, 2008. She becomes an eligible individual on April 1, 2008 and remains an eligible individual through December 31, 2009. She contributes $5,800 on April 2, 2008. She was ineligible for the first 3 months of 2008 because she was also covered by a non-HDHP. The full contribution rule applies and since there was no cessation of HDHP coverage during the testing period, no portion of the $5,800 must be included in income nor will any portion be subject to the special 10% tax.

Example #3. Mary, age 59, becomes covered by a family HDHP on December 1, 2008 and she is otherwise eligible. She was not an eligible individual for any of the preceding 11 months. She remains an eligible individual through December 31, 2009. She contributes $6,700 ($5,800 plus catch-up of $900) on December 2, 2008. The full contribution rule applies and since there was no cessation of HDHP coverage during the testing period, no portion of the $6,700 must be included in income nor will any portion be subject to the special 10% tax.

Example #4. Marlene age 39, is first covered under a self-only HDHP on May 1, 2008. She is also eligible as of June 1 and July 1. The full year contribution rule does not apply since there was no HDHP coverage as of December 1, 2008. Her maximum contribution is $725 (3/12 of $2,900).

Continued on page 8

The Pension Digest

**HSA Contributions,
Continued from page 7**

Example #5. Brian, age 39, becomes covered by a family HDHP on January 1, 2008 and he is otherwise eligible. On September 1, 2008 he switches to self-only HDHP Coverage until December 31, 2008. He becomes covered by a non-HDHP on January 1, 2009. For 2008, he contributes $4,833.33 (8/12 x $5,800 plus 4/12 x $2,900). He based his contribution on the sum of the monthly limitations rule and not the full contribution rule. Thus, there was no cessation during the testing period and there is no requirement to include any portion of the $4,833.33 in income or pay any 10% tax.

Example 6. Mark, age 49, is first covered under a family HDHP on December 1, 2008 and is otherwise eligible. He was HSA ineligible for the first 11 months. His maximum contribution is $5,800 and he makes this contribution December 1. He ceased to be an eligible individual in June of 2009. This cessation occurs during the testing period. David will include in his 2009 income the amount of $5,316.67 ($5,800 - $483.33) and he will owe the penalty tax of $532 (10% x $5,316.67). Mark is unable to withdraw the $5,316.67 as an excess contribution. It is not an excess contribution as it was permissible when done.

Example 7. Mike, age 35, becomes covered by a self-only HDHP on June 1, 2008 and he is otherwise eligible. He contributes $2,900 on June 1, 2008. The full contribution rule applies as he is an eligible individual and he still maintains self-only HDHP coverage on December 1, 2008. He remains an eligible individual until February 1, 2009. On February 2, 2009, he withdraws $1,208.33 and uses it to pay non-qualified medical expenses. He was eligible to contribute $2,900. However, his HDHP coverage did end during the testing period. This means he must include in income $1,208.33 ($2,900 - $1,691.67 or $120 x 7/12) and he must pay the 10% tax on the $1,208.33 or $120.83. In addition, he took an actual distribution of $1,208.33 and did not use it to pay qualified medical expenses. He will include the $1,208.83 in income a second time (for a different reason) and also pay the 10% additional tax since he is not age 65.

Example 8. Ron, age 64, becomes covered by a family HDHP from April 1, 2008 to December 31, 2008 and he is otherwise eligible. He contributed $6,700 on April 1, 2008 for 2008. The full contribution rule authorized him to contribute $6,700. Ron attains age 65 and he enrolls in Medicare on March 24, 2009. His Medicare enrollment means he becomes ineligible during the testing period which runs until December 31, 2009. He will need to include in income the amount of $1,675 ($6,700-$5,025) and he will owe the additional tax of $167.50 ($1,675x10%).

Example #9. Same facts as #8 except Ron became disabled. He continued to be covered by his family HDHP until he enrolled in Medicare. Enrolling in Medicare made him ineligible for an HSA. The general rule is that a person (even age 65 or older) who uses the full year contribution rule and then becomes HSA ineligible during the testing period, is required to include in income the difference between the full year contribution amount and what he was qualified to contribute using the monthly limitations rule. This amount is also subject to a special 10% tax. However, there are two exceptions so that the adverse tax consequences will not be assessed when his ineligibility is due to disability or death. In this case, the disability exception applies and he is not required to include the $1,675 in income or pay the special 10% tax ($167.50).

Example 10. Karen, age 46, becomes covered by a family HDHP on January 1, 2008 and she is otherwise eligible. She contributes $5,800 on January 2, 2008. She becomes covered by a non-HDHP on August 1, 2008. She realizes she was allowed to only contribute $3,383.33 ($5,800 x 7/12). This means she made an excess contribution of $2,416.67 ($5,800-$3,383.33). She withdraws that amount plus earnings of $40 or $2,456.67. This is a true withdrawal of an excess contribution situation. She does not owe the 6% excess contributions tax for 2008 because she corrected the excess. The $45 will be included on her 2008 tax return. She will explain that the $2,416.67 is not to be included in her income since she withdrew an excess HSA contribution. The full contribution rule never applied as she had no HDHP coverage as of December. Consequently, the tax penalties associated with a testing period do not apply. ◆