The ins and outs of IRA-to-HSA rollovers

By Kelley C. Long, CPA/PFS

Savers who are focused on the wealth-building features of health savings accounts (HSAs) are often surprised to learn that they can roll funds from an individual retirement account (IRA) into their HSA, which is called a qualified HSA funding distribution. However, before practitioners start calling clients about this lesser-known rule, a word of caution — this provision is less exciting than it might sound at first, and like all things HSA-related, it can get complicated.

Taking a qualified HSA funding distribution from an IRA

The most important thing to know about a qualified HSA funding distribution is that it is a once-in-a-lifetime opportunity for each HSA account holder. The second most important thing to know is that the maximum amount of the rollover is limited to the amount of that year's HSA contribution limit.

Also important to know is that the amount of the rollover reduces the taxpayer's HSA contribution limit for the year the distribution is made. Practically, this means that to avoid excess contributions to an HSA, a taxpayer who has employer contributions or has already made contributions to the HSA in the rollover year should limit the rollover amount to the contribution limit for the year less the previous employer contributions and other contributions.

The main advantage of an IRA-to-HSA rollover is that the funds, if taken from a traditional IRA, will end up in a more tax-advantaged account because HSAs are "triple tax-free" (no tax on contribution, growth, or qualified withdrawal).

Deciding when to perform this rollover from a wealth-building perspective is important in terms of rolling over the maximum amount. For example, someone under age 55 enrolled in an HSA-eligible health care plan with individual coverage through an employer would be able to roll over only $3,650 in 2022 or $3,850 in 2023 (the annual HSA contribution). However, if that same person waits until they are age 55, assuming the same employment situation, they will have an additional $1,000 rollover amount due to the catch-up rules.

An ideal situation for an IRA-to-HSA rollover would be a year when the account holder has family coverage and is age 55 or older — for 2022, that would allow $8,300 to be rolled over; $8,750 in 2023. If the account holder's spouse also has an HSA account and is age 55 or older, the spouse could also rollover $1,000 from his or her own IRA to the HSA, giving the couple almost $10,000 of eventual tax-free income from their IRAs.

If a client's health insurance coverage changes from individual to family in the same tax year that the client has already performed the rollover according to individual coverage, they could perform a second rollover to reach the family limit. Note the testing period rules discussed below, however. Each contribution would be subject to its own testing period.

Using a traditional IRA vs. Roth IRA vs. other retirement accounts

Qualified HSA funding distributions can be made from either a traditional or a Roth IRA, but not from an *ongoing* SEP-IRA or SIMPLE IRA ("ongoing" meaning the employer contributes to the IRA in the same year as the qualified distribution to the HSA). While direct rollovers cannot be made from employer-based retirement accounts such as 401(k), 403(b), or 457 accounts, the client could first perform a rollover from the employer-based retirement plan to an IRA and then to the HSA.

Using the Roth IRA to fund the HSA

Generally speaking, it makes the most sense to use traditional IRA funds that would otherwise be taxed upon withdrawal to perform this rollover.

Only rarely would it make sense to use Roth IRA funds for it. The circumstances generally would involve the need to fund current medical expenses (which is most likely the rollover rule's original intent). That is, the taxpayer has medical expenses that need to be paid, and the Roth is the best source to pay the bills.

It still wouldn't make sense to use a Roth IRA in this case unless the alternative options for paying the medical expenses would put the client in debt and other options aren't available, such as 0% payment plans through the medical provider or even a 401(k) loan. In this case, the client should first make a direct withdrawal from the Roth IRA of any contributions.

If that's still not enough to cover the medical expense, then a qualified HSA funding distribution up to the annual HSA limit for the year can help avoid the 10% early withdrawal penalty on earnings. In other words, the only time it would really make sense to take a qualified HSA funding distribution from a Roth IRA would be when it's the only way to avoid the Roth IRA early withdrawal penalty and there are no other funds available to pay the medical bills without incurring high interest rates.

Meeting the testing period

Probably the biggest pitfall of the qualified HSA funding distribution is when taxpayers fail the testing period, which states that the account holder must be enrolled in an HSA-eligible plan at the time of the rollover *and* they must stay enrolled in an HSA-eligible plan for at least 12 months from the rollover date. If the testing period is failed, the entire distribution will be included in income and subject to an additional 10% tax.

For clients approaching Medicare enrollment, this is especially important to note — if the rollover is performed less than 12 months before joining Medicare, the enrollment will automatically disqualify HSA contributions and the testing period will be failed. This means that pre-retirees wishing to perform an IRA-to-HSA rollover before joining Medicare upon reaching age 65 need to plan ahead at least 12 months before the month they turn 65.

For clients postponing Medicare enrollment beyond age 65 due to eligible coverage, the rollover needs to consider the six-month lookback for Medicare Part A enrollment when calculating their testing period if they wish to wait as long as possible to perform their once-in-a-lifetime rollover. (On the six-month lookback, see "Medicare's Tricky Rules on HSAs After Age 65," *JofA*, July 2021).

If a client misses the window to perform the direct rollover prior to Medicare enrollment, they could still take a qualified distribution from their IRA and use those funds to contribute to the HSA, effectively using the HSA deduction to cancel out the taxation of the IRA distribution. Performing the rollover directly will avoid tax withholdings of the IRA distribution, however.

The logistics of the rollover

A qualified HSA funding distribution must be initiated by the IRA custodian and performed as a trustee-to-trustee transfer. Clients with their accounts at separate providers may wish to contact their HSA provider first to obtain any special instructions to share with the IRA provider. An indirect rollover, where the client requests a distribution from their IRA and then sends it to their HSA, does *not* qualify.

Rollovers also must be done using cash and are reported on Form 8889, *Health Savings Accounts (HSAs)*, attached to Form 1040, *U.S. Individual Income Tax Return*.

So, while the situation can get complicated, awareness of the rules can help clients time their once-in-a-lifetime IRA-to-HSA rollover to realize maximum tax savings.

For more information on HSAs, listen to the PFP Section podcast episodes "Unique and Under-Communicated HSA Benefits" and "How Medicare Enrollment Impacts HSA Contributions." PFP Section members can consult the Guide to Financial and Estate Planning — Vol. 2.

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