377.01 What is the “testing period” for HSAs?

An HSA testing period is a rule that requires HSA account owners in some circumstances to maintain their HSA eligibility for a period of time after making an HSA contribution.[[1]](#endnote-1) Congress created the testing period rules when it passed the Health Opportunity and Patient Empowerment Act of 2006, a law allowing HSA account owners to fully fund an HSA up to the IRS limits for a year even if they were not HSA eligible for the full year (this is commonly referred to as the “full contribution rule” or the “last month rule”).[[2]](#endnote-2) The full contribution rule only applies to individuals eligible on the first day of the last month of the tax year (December 1 for calendar year taxpayers). The full contribution rule partially replaced the sum-of-the-months rule that limited HSA contributions to a pro-rata amount of the IRS maximum based on the number of months a person was eligible for an HSA (See Q 372) The testing period serves to plug a potential loophole that would have allowed individuals to make a full HSA contribution and then switch to traditional health insurance (i.e. allow individuals to benefit from the HSA tax deduction without being exposed to the high deductible required under an HDHP).

The testing period rules apply in two circumstances[[3]](#endnote-3):

1. HSA account owners that were HSA eligible on the first day of the last month of their tax year must meet a testing period (December 1 for calendar year taxpayers). This includes people that just started their HSA eligibility on the first day of the last month (December 1) as well as someone that started eligibility during the tax year and remained eligible on the first day of the last month. It does not include someone that was eligible for part of the year not including the first day of the last month of their tax year (i.e. an individual that lost HSA eligibility before the last month of the individual’s tax year).
2. An HSA account owner using a tax-free distribution from an IRA to fund his or her HSA must meet a testing period.

In other words, any calendar-year taxpayer who makes a regular HSA contributions and remains eligible on December 1 is subject to a testing period. Or, anyone who completes an HSA qualified funding distribution from an IRA is also subject to the testing period rules. This means that most participants in an HSA, those who make contributions every year and remain eligible year after year, are subject to the testing period rules. However, the impact of the rule only applies to individuals that start eligibility after the beginning of the tax year and remain eligible on the first day of the last month of the tax year or move money from an IRA to an HSA in an HSA qualified funding distribution. Individuals eligible every month of a year will not face any additional taxes or penalties based on a failed test period for that year. Individuals that are eligible during the year but lose eligibility prior to the first day of the last month of the tax-year are not subject to the testing period rule because they are not granted the benefit of the full contribution rule.

The testing period for regular HSA contributions runs from the first day of the last month of the tax year (December 1 for calendar year taxpayers) until the last day of the twelve month following that month (December 31 of the following year for calendar year taxpayers). For HSA qualified funding distributions from an IRA, the testing period runs from the month of the rollover until the last day of the 12th month following that month (i.e. thirteen months counting the month of the rollover). The individual must remain eligible for an HSA during the test testing period or fail the testing period. If an individual faces both testing periods, the two tests are run separately.

The individual is responsible to understand the testing period rules, track the testing period and report any failures of the testing period. Neither the HSA custodian nor an employer bears any responsibility for tracking the testing period.

Individuals that fail to meet the testing period must calculate the amount of an HSA contribution they could have made under the sum-of-the-months rule and then compare that amount to their actual contribution for the year being tested. If their actual contribution is larger, the HSA account owner will owe taxes and penalties on the difference. If their actual contribution is the same or less than the sum-of-the-months rule, then no tax or penalty is owed. The sum-of-the-months calculation determines the amount that a taxpayer would have been allowed to contribute under the pre-2007 law and a failed testing period essentially results in a taxpayer having to return to that potentially lower contribution amount.

Accordingly, HSA account owners that fail the testing period first need to calculate their sum-of-the months’ amount. The IRS provides a sample calculation in its HSA Publication 969.[[4]](#endnote-4)

The penalty is 10 percent of the amount of over contribution (the difference between the amount contributed and the sum-of-the-months calculated amount). Plus, the HSA account owner owes federal and possible state income taxes on that amount. An exception exists if the failure to remain HSA eligible while under a testing period for the HSA results from death or disability. This exception applies to both the full contribution year testing and to IRA to HSA funding testing periods.[[5]](#endnote-5)

HSA account owners pay the tax and penalty on IRS Form 8889, Part III. This form is a required attachment to the IRS Form 1040 series for HSAs account owners in any year an HSA account owner makes a contribution or takes a distribution so most HSA account owners are filing this form anyway and will just need to complete the additional section.

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**Practice Pointer:** Failing a testing period is not treated the same as excess contribution (See Q 377). The two issues share a common origin, an account owner contributed too much money into an HSA. Accordingly, some individuals mistakenly correct failed testing periods using the excess contribution rules. This is incorrect and creates more taxes and penalties.

An excess contribution results from contributing more than the HSA limits allow. An excess contribution is corrected by removing the excess. A failed testing period results from an individual subject to the testing period not remaining HSA eligible for the testing period. A failed testing period is corrected by paying taxes and penalties on the calculated amount (the amount contributed under the full contribution less the amount calculated under the sum-of-the-months rule). This tax is paid directly by the individual on IRS Form 8889. The actual dollars are not removed from the HSA. This is counter-intuitive for most people. The IRS has trained the industry over the years that if someone puts too much money into an HSA or IRA, they need to take it out. Excesses are removed. Not in this case, the calculated overage amount remains in the HSA for a failed testing period.

An HSA account owner that treats a failed testing period as an excess contribution will owe taxes and penalties twice.[[6]](#endnote-6) Once for failing the testing period (taxes plus a 10% penalty) and a second time for a non-qualified HSA distribution (subject to taxes plus a 20% penalty). An HSA account owner that is disabled or deceased is granted an exception for a failed testing period. Disability, death and attainment of the age 65 are exceptions to the 20% distribution from the HSA.

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1. IRC Sec. 223(b)(8). [↑](#endnote-ref-1)
2. Health Opportunity Patient Empowerment Act of 2006 included in the TRHCA 2006. [↑](#endnote-ref-2)
3. IRS Notice 2008-52. [↑](#endnote-ref-3)
4. IRS Pub 969. [↑](#endnote-ref-4)
5. IRC Sec. 223(b)(8)(B)(ii). [↑](#endnote-ref-5)
6. IRS Notice 2008-52, Ex-9; IRS Notice 2004-50, A-35 [↑](#endnote-ref-6)