

Transformation of HSAs in 2007; Implications of the Tax Relief and Health Care Act of 2006

On December 11, 2006, the Senate approved the Tax Relief and Health Care Act 2006 (Act). This Act makes significant changes to Health Savings Accounts (HSAs). The President is expected to sign the Act into law, thereby making the changes effective January 1, 2007. Should this Act become law, it will impact many employers sponsoring HSAs. The following summarizes the provisions of the Act as it relates to HSAs.

Increased HSA Contribution Limits

The current law caps HSA contributions to the lesser of 1) the High Deductible offered under the high deductible health plan (HDHP), or 2) the statutory maximum (\$2,850 single/ \$5,650 family). The Act eliminates the “lesser of” requirement and allows a contribution limit up to the Statutory Dollar Maximum. In 2007, an employee covered by a HDHP with a \$1,200 single deductible would be able to contribute \$2,850 toward their HSA over the plan year.

Mid-Year Contributions

There is a significant change to the treatment of individuals enrolling mid-year on a HDHP/HSA plan. An individual who is eligible for an HSA during the last month of the taxable year shall be treated as having been eligible during each month of the taxable year. As a result the individuals may make HSA contributions up to the annual maximum. In order to avoid negative tax implications, the individual must remain HSA-eligible during the “testing period.” The “testing period” is the period beginning with the last month of the taxable year and ending the last day of the 12th month following such month. Failure to maintain eligibility would treat contributions as income for tax purposes and impose a 10% penalty tax on the contribution amount.

For example, if the HSA plan is on a January 1, 2007 – December 31, 2007 plan year and an eligible individual enrolls in the plan in July and makes contributions up to the annual maximum for the year, the individual is deemed as having been covered for the entire year since he/she has coverage on December 31, 2007. This individual would need to remain eligible for the following 12 months in order to avoid tax consequences on the contributions. The taxes and penalty do not apply if the person loses eligibility due to death or disability.

This is a significant departure from the current law, which only allows individuals to make contributions in each calendar month for which they were HSA-eligible, even though they are subject to the full annual deductible. Under the current law, the individual in the above scenario would only be able to make HSA contributions from July 2007 through December 2007.

Transfer of Existing HRA and FSA Funds into an HSA

The Act provides a five-year window for an employer to make a one-time transfer of Health Flexible Spending Account (FSA) or Health Reimbursement Arrangement (HRA) balances to an HSA for their employees. The amount transferred may not exceed the lesser of 1) the balance in the FSA or HRA account as of September 21, 2006, or 2) the balance on the date of transfer. The transfer is treated as a rollover; therefore the amount transferred will not reduce the account holder's annual contribution for the year.

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The employee must remain covered by an HDHP (or otherwise eligible HSA) for a 12 month period after the balance transfer. Transferred balances will be taxable income and a 10% penalty tax will be imposed if the individual fails to remain HSA eligible during this period. The taxes and penalty do not apply if the person loses eligibility due to death or disability.

This balance transfer option is a sunset provision and will expire on December 31, 2011.

It is likely that the provisions of the health FSA or HRA plan document would need to be amended to include an HSA balance transfer.

FSA Grace Period & HSA eligibility

Currently, coverage under a health FSA with a Grace Period will disqualify an individual from HSA eligibility. This is currently the case even if the individual has a zero balance in their health FSA.

However, under the Act, a special provision exists to allow otherwise eligible HSA participants to make contributions to their HSA. In order to benefit from this special provision, a person must be participating in the health FSA with a grace period at the end of the prior year and such participation is the only reason they are disqualified from contributing to the HSA. The participant cannot have other disqualifying coverage (i.e. non-high deductible coverage through a spouse). The Act permits the individual to make HSA contributions provided:

1. The FSA balance was zero at the end of the prior FSA year, or
2. The individual made a balance transfer of FSA funds to the HSA as of the end day of the plan year.

For example, assume a January 1, 2006 - December 31, 2006 health FSA plan year with a 2 month and 15 day grace period (March 15, 2007 expiration). Under the old law, the participant would be ineligible to make contributions to the HSA until April 1, 2007. Provided the above conditions are met, the individual would be eligible to make contributions to the HSA for January, February and March.

Again, the health FSA plan document may need to be amended to reflect this change.

Rollovers from an IRA to an HSA

Another feature provided under the Act is the ability to distribute Individual Retirement Account (IRA) funds into an HSA. This is a one-time tax free irrevocable transfer and must be done directly from trustee to trustee. The amount of the rollover cannot exceed the statutory maximum based on the HDHP coverage being provided to the individual at the time of the transfer. The Act provides an exception where an IRA transfer was made to an individual covered as a "single" for purposes of the HDHP. If in the same taxable year, the individual moves to "family" status, they may make a second IRA transfer to meet the larger deductible under the family HDHP plan.

Unlike the health FSA, it appears distributions from an IRA to an HSA will be included in the annual contribution maximum for the HSA. They are not treated as rollover contributions.

If the individual ceases to remain HSA eligible during the month of the transfer or the following 12 month period, then the amount of the transfer becomes taxable income and a 10% penalty will apply. The taxes and penalty do not apply if the person loses eligibility due to death or disability.

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Comparable Contributions

An employer may contribute to the HSA of their employees either through a cafeteria plan or outside of such arrangement. The current law requires an employer to make comparable contributions to the HSAs of all comparable employees when contributing outside of the cafeteria plan. The Act loosens the restrictions on comparability and allows the employer to ignore Highly Compensated Employees (HCEs) when considering who is a comparable employee. A HCE is defined by the qualified retirement plan rules under the Tax Code. This change makes it easier to contribute a larger dollar amount to the lower paid workers' HSAs than to the HCEs' HSAs. However, most employers make HSA contributions through a cafeteria plan therefore they are removed from comparability requirement, instead subject to Section 125 nondiscrimination rules.

Cost of Living Adjustments

The Act mandates that cost of living adjustments to the HSA plan components be announced by June 1 of the prior plan year.

Conclusion

The above is a summary of the implications to HSAs as a result of the Tax Relief and Health Care Act. The Act is anticipated to be signed into law by President Bush in the next few weeks and will impact plans on January 1, 2007. This information is still developing and there are many unanswered questions. When (and if) the Act is signed into law it is expected that the IRS will propose regulations or provide additional guidance on the implementation of these new aspects. As always we will keep you posted on the new developments surrounding this significant change.