GROOM LAW GROUP

January 4, 2007

MEMORANDUM TO CLIENTS

RE: HSA Provisions in the Tax Relief and Health Care Act of 2006

On December 20, 2006 President Bush signed into law the Tax Relief and Health Care Act of 2006 (H.R. 6111) (the "Act"), which was approved by the House of Representatives on December 8, 2006 and by the Senate on December 9, 2006. The Act includes several significant Health Savings Account ("HSA") provisions, such as increases to the HSA contribution limits and administrative simplifications. The HSA provisions were a late and largely unanticipated addition to the Act, which is primarily aimed at extending expiring tax provisions and making certain other changes to the tax, trade and Medicare laws. The HSA provisions are the same as those that appeared in H.R. 6134, an HSA bill that was approved by the Ways and Means Committee on September 27, 2006.

The inclusion of the HSA provisions in H.R. 6111 is particularly significant because H.R. 6111 was one of the final acts of the 109th Congress. Because Democrats will control the House and Senate in the next Congress, it is unlikely that any other legislation to expand HSAs will be enacted anytime soon.

Specifically, the Act does the following, generally effective for taxable years after December 31, 2006, except where noted otherwise:

- **Modifies the limit on contributions to HSAs, so that it is not limited to the annual deductible of the high deductible health plan (HDHP); instead, contributions would be limited only by indexed dollar amount ($2,850 self-only; $5,650 family for 2007).**

  Under current law, HSA eligible individuals may make HSA contributions up to the lesser of (i) 100% of the annual deductible limit of the eligible individual's high deductible health plan ("HDHP") or (ii) $2,850 for self-only and $5,650 for family coverage for 2007 (indexed for inflation). Under this rule, it is unlikely that an individual who incurs any significant medical expenses could accumulate amounts in the HSA from year to year. Under the new provision, eligible individuals will be able to contribute up to $2,850 (self-only) or $5,650 (family) for 2007, regardless of the annual deductible under the individual's HDHP. Allowing an individual to contribute more than the HDHP deductible to his or her HSA increases the likelihood that some amounts in the HSA will carry over from year to year.

- **Requires the Secretary of Treasury to announce the cost-of-living adjustments applicable to HSAs by June 1 of each year. This change is effective for tax years beginning after 2007.**

  Each year, certain key figures relating to the HDHP limits and the amount that an individual can contribute to an HSA are adjusted for inflation, as required by section 223(g)(1) of the Code. Under current law, the cost-of-living increase is based upon information from the Bureau of Labor and Statistics (BLS)-- specifically, the average consumer price index ("CPI") as of the close of the 12-month period ending on August 31, as described in Code section 1(f)(4). The IRS announces the new limits in a Revenue Procedure that is generally published in November each year, which is widely viewed as providing an inadequate amount of lead time for insurance companies and other HSA providers who are offering HDHP/HSA products and employers who are distributing open enrollment materials for the following year. The new provision changes the dates for which the CPI is measured to the 12-month period ending on March 31st of the calendar year, allowing the calculation to be performed earlier in the year. The new provision also requires the Secretary of Treasury to announce the cost-of-living adjustments applicable to HSAs by June 1 of each year.

- **Allows individuals who become covered by a HDHP after January to contribute up to the full annual limit, even if they were only eligible individuals for a portion of the taxable year.**

  Under current law, an individual who enrolls in an HDHP mid-year is subject to the minimum annual deductible under the HDHP, but such individual's maximum HSA contribution limit is reduced on a pro-rata basis for each month that the individual did not have HDHP coverage as of the first day of the month. The new provision corrects this disparity and provides that an individual who becomes an HSA-eligible individual in any month after January may make the full HSA contribution for the year (e.g., $2,850 for self-only coverage for 2007). If, however, an individual who becomes an HSA-eligible individual mid-year is no longer an eligible individual at any time during the 13-month period beginning with the last month of that year, the contribution amounts attributable to the months preceding the month in which the individual became HSA-eligible are includible in income and subject to a 10% additional tax.

- **Permits an individual to transfer the balance remaining in his or her FSA or HRA account as of September 21, 2006 (or, if less, the balance on the date of the transfer) to an HSA. The transfer must be made before January 1, 2012.**

  Under current law, no transfer from a flexible spending arrangement ("FSA") or health reimbursement arrangement ("HRA") to any other type of account, including an HSA, is permitted. Making such a transfer would violate sections 106 and 105 of the Internal Revenue Code ("Code") that apply to FSAs and HRAs, and would result in adverse tax consequences for the participant and the employer. Effective after the date of enactment, this provision allows a one-time transfer from an FSA or HRA to an HSA and specifies that transferred amounts are excludable from wages for income and FICA tax purposes

Such amounts are not deductible under Code section 223 and are not subject to the maximum contribution limit (transferred amounts do not count against the maximum contribution limit). If, at any time during the 13-month period beginning with the month of the transfer, an individual is no longer an eligible individual (e.g., is no longer covered by an HDHP), the transferred amounts are includible in income and subject to a 10% additional tax. Employers allowing any employee to make the one-time transfer must make it available to all eligible individuals covered by an HDHP of the employer.

- **Allows coverage under a health FSA during the "2-1/2 Month Grace Period" to be disregarded for eligible individuals who have a zero balance in their HSA at the end of the previous calendar year.**

  Under current law, an individual covered under a health flexible spending arrangement ("FSA") is generally precluded from contributing to an HSA. Pursuant to Notice 2005-42, FSA plan sponsors may allow FSA participants to continue to incur qualifying medical expenses up to March 15th following the close of the plan year (the "2-1/2 month grace period"). According to Notice 2005-86, an individual participating in an FSA that incorporates the 2-1/2 month grace period generally may not contribute to an HSA until the first month following the end of the 2-1/2 month grace period, even if the participant's account balance is "zero." Under the new provision, a participant in an FSA that incorporates the 2-1/2 month grace period may nonetheless contribute to an HSA during the grace period if his or her account balance is "zero" as of the end of the previous plan year. Alternatively, if the FSA participant maintains amounts in his or her account balance at the end of the plan year, the participant may make a one-time transfer of the balance to an HSA (in accordance with rules prescribed by Treasury and the rules discussed above). This provision is effective on date of enactment.

- **Allows employers to make contributions to HSAs on behalf of non-highly compensated employees in higher amounts (or higher percentages of deductibles) than to highly compensated employees without violating the comparable contribution rules.**

  Code section 223 and final regulations under Treas. Reg. § 54.4980B-1 through 5 provide that if employers make contributions to the HSAs of employees, those contributions must generally be either the same amount or the same percentage of the HDHP's deductible for the year. These rules do not apply to employer contributions that are made through a Code section 125 cafeteria plan.

  The comparable contribution rules generally preclude an employer from making contributions to HSAs on behalf of non-highly compensated employees ("NHCEs") in higher amounts (or higher percentages of deductibles) than to highly compensated employees ("HCEs"). Under the new provision, employers are permitted to make greater HSA contributions on behalf of NHCEs, but must satisfy the comparability rules with respect to contributions to NHCEs. For example, an employer may make a $1,000 contribution on behalf of each NHCE without making any contributions to HCEs. For these purposes, HCEs are defined under Code section 414(q), which generally means that individuals who earn less than $100,000 (for 2007) will be considered NHCEs.

- **Allows individuals to make a one-time distribution to rollover amounts from an IRA to an HSA, subject to the HSA contribution limit.**

  Under current law, no amount may be rolled over from an individual retirement account ("IRA") to an HSA. The new provision allows a one-time rollover from an IRA into an HSA. Such amounts are not includible in income, nor subject to the 10% additional tax applicable to early withdrawals from an IRA. The transfer amount is not deductible and counts against the maximum HSA contribution limit for the year (e.g., $2,850 for self-only and $5,650 for family coverage for 2007). An individual with self-only coverage who transfers amounts from his or her IRA to an HSA may subsequently make an additional transfer if the individual switches to family coverage. The maximum amount of the additional transfer is equal to the difference between the amount transferred while the individual had self-only coverage and the maximum deductible limit for family coverage for the year. Similar to the one-time rollover from an FSA or HRA, if, at any time during the 13-month period beginning with the month of the transfer, an individual is no longer an eligible individual, the transferred amounts are includible in income and subject to a 10% additional tax.

If you wish to discuss these changes or other HSA legislative proposals, please contact Bill Sweetnam, Brigen Winters or Chris Keller at (202) 857-0620.