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Recent Legislation Increases Flexibility of Health Savings Accounts

As our clients' interest and participation in Health Savings Accounts (HSAs) continue to grow, we at Moreton & Company want you to be aware of some new important legislation affecting HSA plans. This last December, Congress passed the Tax Relief and Health Care Act of 2006, which President Bush signed into law on December 20, 2006.

For the past few years, HSAs have been available to employers as an alternative employee health benefit arrangement. HSAs are a portable, individual tax-advantaged medical savings account to which employers and employees may contribute. To participate, an individual must be enrolled in a high deductible health plan, and with limited exceptions the employee may have no other coverage. To encourage more employers to implement HSAs, the new law seeks to alleviate some previous inflexible HSA restrictions.

Some key points of the legislation are below. All changes are effective January 1, 2007, unless otherwise noted.

- **High Deductible Health Plan (HDHP) Deductible Won't Limit Annual HSA Contribution.** Under the old rules, an individual's annual HSA contribution could not exceed the annual deductible under his/her HDHP. Now, HSA-eligible individuals can contribute up to the annual statutory limits regardless of their deductible. For 2007, that is \$2,850 for self-only HDHP coverage and \$5,650 for family HDHP coverage.

➤ **Employer action:** Consider whether Cafeteria Plan document changes are necessary to allow participants to contribute up to the new, higher limits.

- **Mid-Year Enrollees Can Make Full-Year HSA Contribution.** Under the old law, an individual who enrolled in the HDHP mid-year could make only prorated HSA contributions based on the number of months he or she was eligible. Now the HSA contribution limits are not prorated if the individual is HSA eligible during the last month of the tax year. So if he or she is enrolled in the plan in December, the full annual HSA contribution can be made. However, if the individual does not remain HSA eligible during the following tax year (other than for death or disability), the portion of HSA contributions attributable to months that he or she was not HSA eligible will be includible in gross income and subject to a 10% penalty. Note that employers contributing to their employees' accounts can choose whether to contribute up to the full maximum for mid-year enrollees.

➤ **Employer action:** Consider whether Cafeteria Plan document changes are necessary to allow mid-year enrollees to contribute up to the full HSA contribution limit.

- **Limited IRA Rollovers Allowed.** The Act now allows employees to make a one-time tax-free rollover from an individual retirement account ("IRA") to an HSA, provided the rollover amount does not exceed the annual HSA contribution limit and HSA coverage is maintained for at least 12 months. Note there are adverse tax consequences if the individual ceases to be HSA eligible during this time. There is a limited exception to the one-time transfer rule if an individual made a transfer when he or she had self-only HDHP coverage and switches to family HDHP coverage later during the same taxable year. In this case the individual can make one additional transfer that does not exceed the annual HSA contribution limit for family coverage, less the earlier HSA funding distribution.

➤ **Employer action:** None required.

- **Limited Health FSA and HRA Rollovers Allowed.** The Act now allows employers to make a one time transfer of an employee's Health Flexible Spending Account (FSA) or Health Reimbursement Account (HRA) balance into an HSA. The transferred amount cannot exceed the balance in the employee's health FSA or HRA as of 9-21-06, and the transfer must take place between 12-20-06 and 12-31-11. There is a limit of one such distribution per health FSA or HRA, but this transferred amount does not count against

the annual HSA contribution limit. Further, the employee must continue to be HSA eligible for the following 12 months, or otherwise suffer adverse tax consequences.

➤ **Employer action:** Decide whether to amend health FSA or HRA to allow qualified HSA distributions; but caution is advised pending IRS guidance (see below).

- **Employers Can Disregard Health FSA “Grace Period” Coverage.** Until now, employees who were covered by a general-purpose health FSA under which coverage was extended during the grace period following the plan year (up to 2 ½ months) were not HSA eligible until after the grace period. This was true even if the employee had a \$0 balance in the health FSA at the end of the plan year. Now under the Act, the health FSA grace period coverage will be disregarded (meaning the employee is HSA eligible) if the health FSA has a \$0 balance at the end of the plan year, or if the entire remaining health FSA balance is rolled into the HSA by plan year end.

➤ **Employer action:** Consider whether Cafeteria Plan changes are necessary to allow participants with \$0 balances at year-end to make HSA contributions during the health FSA grace period.

- **Employers Can Make Higher HSA Contributions To Non-highly Compensated Employees.** Previously, if HSA contributions were made outside of a Cafeteria Plan, employers were required to make comparable contributions for all eligible employees with the same category of coverage (single, family, etc.). The Act now provides an exception to the “comparability rules,” so that employers making HSA contributions outside the Cafeteria Plan may make larger contributions to non-highly compensated employees than to highly compensated employees.

➤ **Employer action:** Decide whether to contribute more for non-highly compensated employees and if so, adjust comparability testing methods.

Comment: The higher contribution limits will make HSAs more attractive for some employees, and qualified HSA distributions from health FSAs and HRAs may provide planning opportunities for employers transitioning to HDHP coverage. However, the timing of this legislation made it difficult for employers to take action before the end of 2006, and there are many issues that still need to be clarified in agency guidance expected as early as late January. Recognizing that many employers with calendar-year health FSAs have already completed 2007 open enrollment, those that allow employees to make HSA contributions through Cafeteria Plans should review their plan language and consider whether any changes are necessary before implementing. As mentioned above, Moreton suggests waiting for agency guidance before deciding whether to add a qualified HSA distribution feature to your health FSA or HRA, as this aspect of the Act needs to be fleshed out, and adding a noncompliant feature could jeopardize the tax-favored status of the plan. Further, guidance is needed to resolve uncertainties regarding whether a participant’s health FSA balance takes into account the uniform coverage amount or only actual contributions.

➤ If you would like to discuss amending your Cafeteria Plan document in accordance with the Act, please contact your Moreton & Company Consultant. If you have questions about the legislation, please contact:
Laura Wilkins, Vice President, In-House Employment Counsel
Moreton & Company
801-715-7052
lwilkins@moreton.com

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