

Changes to Health Savings Accounts for 2007

Congress recently passed the Tax Relief and Health Care Act of 2006. This legislation includes the Health Opportunity Patient Empowerment Act of 2006 ("Act"), which contains provisions related to Health Savings Accounts ("HSAs"). HSAs are tax-advantaged vehicles through which individuals enrolled in certain high-deductible health plans ("HDHPs") can save money to pay for qualified medical expenses. President Bush signed the legislation this morning. Enactment of this law will make a number of changes to HSAs that may make enrollment in HDHPs more attractive for many consumers.

Highlights of the HSA provisions include:

HSA contribution limit increased

Under current law, the maximum monthly contribution that an eligible individual can make to an HSA is the lesser of 1/12 of the deductible under the HDHP or the amount specified under section 223 of the Internal Revenue Code ("Code") for self-only and family coverage. The Act eliminates the limit imposed by the HDHP deductible and will now allow eligible individuals to contribute up to the annual maximum determined by the Code, which for 2007 is \$2,850 for those enrolled in self-only coverage and \$5,650 for those enrolled in family coverage.

Transfers from Health FSAs and HRAs

In order to facilitate the growth of funds in an individual's HSA, the Act establishes a limited time during which an individual can transfer funds, tax free, from his or her existing health Flexible Spending Account ("FSA") or Health Reimbursement Account ("HRA") to an HSA. There are restrictions on the transfers. First, the maximum amount that may be transferred is the lesser of the balance in the health FSA or HRA as of September 21, 2006 or as of the date of the transfer. Transfers can be made as of the date the Act is enacted. Second, only a one-time transfer per health FSA or HRA is permitted. Third, the employer must transfer the amount directly to the individual's HSA not later than December 31, 2011. Fourth, the employer must make available to all employees enrolled in its HDHP the opportunity to transfer funds to an HSA. Failure to do so will subject the employer to an excise tax under the HSA comparability provisions of the Code. Finally, if the individual does not remain an HSA-eligible individual for the 12 months following the month in which the transfer is made, the funds transferred will be included in the individual's gross income and will also be subject to an additional 10% tax. At this time, any earnings on the transferred funds do not appear to be subject to the tax, but further clarification of this point may be forthcoming. Also, no tax will apply if the individual dies or becomes disabled during this period. These transfers are considered rollovers under section 223 and will not count toward the maximum annual HSA contribution limits. To the extent questions arise about the transfer process, including how balances should be calculated and how during the plan year transfers can be made, we would expect Treasury to issue guidance in the near-term.

Transfers from IRAs to HSAs

In addition to transfers from health FSAs and HRAs, the Act permits a one-time, irrevocable transfer from one of an individual's IRAs to his or her HSA. The maximum amount of the IRA transfer will be determined by the maximum HSA contributions established by the Code for the year in which the transfer is made. Like the health FSA and HRA

transfer, taxes will be assessed on the transfer amount if the individual is not an HSA-eligible individual for the 12 months following the month in which the transfer was made, and the transfer will not count toward the maximum annual HSA contribution limits. In recognition of the higher contribution limits for family coverage under a HDHP, the Act allows an additional IRA transfer if an eligible individual converts from self-only to family coverage under the HDHP during the same year in which the first transfer was made.

Elimination of Health FSA Grace Period Barrier

Under current law, if an individual is enrolled in another group health plan, including a health FSA, he or she is not eligible to contribute to an HSA. Among other things, the IRS has interpreted this restriction to mean that if an individual is a participant in a general purpose health FSA plan that has adopted the grace period, i.e., that period in the next plan year during which a participant can incur expenses, the cost of which can be reimbursed out of funds remaining in the participant's health FSA for the prior plan year ("Grace Period"), that individual is not eligible to contribute to an HSA during the Grace Period. Under the Act, this restriction is eliminated in certain circumstances. Effective January 1, 2007, individuals enrolled in a HDHP who were enrolled in a health FSA with a Grace Period during the prior plan year may contribute to their HSAs during the Grace Period if (a) they have a zero balance in their health FSA at the end of the prior plan year, or (b) they transfer the remaining health FSA balance under the rule described above. While it is not clear whether a "zero balance" requires all expenses to have been incurred and reimbursed by the end of the prior plan year or simply requires them to have been incurred by the end of such plan year, it stands to reason that people should be eligible to contribute to an HSA if the Grace Period provides no benefit to them because they have no more funds available in their health FSA to reimburse Grace Period expenses. Regardless, elimination of the Grace Period barrier will make it far easier for employees to transition to a HDHP and contribute to an HSA when they were enrolled in a general purpose health FSA with a Grace Period during the prior plan year.

Maximum Contributions for Partial Year Eligibility

In another nod toward increasing HSA balances, the Act treats individuals who are covered under a HDHP during the last month of a taxable year as eligible to contribute to an HSA for the entire taxable year. Assuming the individual meets all other eligibility requirements, he or she can make the maximum annual contribution to his or her HSA, regardless of whether he or she was enrolled in a HDHP for the entire year. Again, however, the individual must remain an HSA-eligible individual during the 12-month period following the end of the month in which the individual enrolled in the HDHP, or he or she will be subject to the income and 10% penalty tax on the contributions he or she was permitted to make as a result of this provision.

Some Comparability Requirements Eliminated

While the HSA comparability requirements do not apply to those employers who permit employees to contribute to their HSAs through a section 125 cafeteria plan, in cases where they do apply, employers can now make greater HSA contributions to non-highly compensated employees than they do to highly compensated employees.

More Notice

Finally, with an eye toward providing employers and employees with better information with which to make plan design decisions and enrollment choices, respectively, the IRS will publish the annual change in the maximum HSA contribution limits by June 1 of each year rather than in late fall, which is the current practice. This will give employers contemplating the offering of a HDHP with an HSA significantly more time to plan for and to communicate with and educate employees about this option.

What Does This Mean For Me?

If you currently offer a HDHP with an HSA or will do so at some point during 2007, these changes will provide enrollees with greater savings opportunities. Because eligible individuals are able to make prospective changes to their HSA contributions on a monthly basis, you may permit employees who have enrolled in a HDHP for the 2007 plan year to increase the amount of their HSA contributions made through payroll deductions to reflect these higher contribution limits. If you do not currently offer a HDHP with an HSA, these changes will simply provide further information about these options as you consider them in the future.

Contact Information

If you have any questions about any of these provisions of the Act, including changes in HSA elections, or questions about changes to your health FSA or HRA plan documents to permit the transfers discussed above, please contact your Ropes & Gray benefits attorney or benefits consultant.

