



Health Savings Accounts: Changes in Law are Final

On December 20, 2006, President Bush signed the Tax Relief and Health Care Act of 2006 (Act). The Act includes some substantial changes to the rules governing Health Savings Accounts (HSAs) and the requirements applicable to high deductible health plans (HDHPs). These changes are expected to make participation in an HSA plan more attractive. The new rules apply to taxable years beginning on or after December 31, 2006.

This issue of For Your Benefit provides an overview of the Act's modifications to the rules surrounding HDHPs and HSAs. The Act includes changes in the following areas:

- Termination of Flexible Spending Arrangement (FSA) or Health Reimbursement Arrangement (HRA) to fund an HSA,
- Treatment of prior coverage under an FSA,
- Limitations on contributions to an HSA,
- Cost of living adjustments,
- Contribution limits applicable to employees covered part of the year,
- Comparable contribution requirements, and
- Distributions from individual retirement plans to fund an HSA.

Termination of FSA or HRA to Fund an HSA

The Act allows a one-time contribution to an HSA from an FSA or HRA. However, this contribution must take place prior to January 1, 2012. The amount contributed to the HSA may not exceed the lesser of the FSA or HRA account balance as of: a) September 21, 2006 or b) the account balance at the time of distribution. Because this contribution is a "qualifying transfer," it does not impact the annual contribution limit.

Treatment of Prior Coverage Under an FSA

As allowed by the IRS rules, some FSA plans allow participants to submit and incur claims for 2½ months after the plan year has ended. This FSA plan design causes an individual to be disqualified from participating in an HSA plan the following year because the 2½ month grace period overlaps with the HSA contribution period. An individual is not eligible to make contributions to an HSA account in the same month he or she also has established an FSA account that reimburses expenses related to medical services that are covered under the individual's HDHP.

Beginning in tax years on or after December 31, 2006, the Act allows individuals covered under an FSA plan which includes a 2½ month grace period to be eligible to establish an HSA the following year if:

- The balance of the FSA is zero at the end of the plan year, or
- The individual transfers his or her unused balance into the HSA at the end of the FSA plan year.

Limitations on Contributions to an HSA

The existing HSA annual contribution limits allow an eligible individual to contribute 100% of the lesser of:

- The actual deductible, or
- \$2,850 for individual coverage and \$5,650 for family coverage. (2007 Calendar Year)



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The Act allows eligible individuals to contribute \$2,850 for individual coverage and \$5,650 for family coverage, regardless of the actual deductible contained within their HDHP. Therefore, it is possible that an individual could make contributions to their HSA account in an amount that exceeds their deductible.

Cost of Living Adjustments

Currently, the IRS adjusts the deductible requirements and contribution requirements each year to reflect an increase in the cost of living. These adjustments are often made in November and are effective the following January – leaving employers little time to modify their plans to comply. The Act requires that the IRS release any cost of living adjustments to the deductible amounts required under a HDHP or annual HSA contribution limits no later than June 1 of the prior year.

Contribution Limits Applicable to Employees Covered Part of the Year

The Act allows individuals who are eligible to contribute to an HSA in the last month of the taxable year to contribute an amount equal to the annual HSA contribution amount. For example, an individual who first becomes eligible to contribute to an HSA on December 1 and who enrolls in an individual HDHP could contribute up to \$2,850 in that taxable year. However, the participant must remain enrolled in a qualified HDHP for 12 months following the contribution. In the example above, if the participant contributed the full \$2,850 in December, but left the HDHP in June of the following year, one-half (6 months) of the contribution must be refunded or the participant will bear a 10% penalty tax for excess contributions.

Comparable Contribution Requirements

An employer is not required to contribute to the HSAs of its employees. However, if an employer makes contributions to any employee's HSA, it must make comparable contributions (that is, the same dollar amount or the same percentage of the HDHP deductible) to the HSAs of all comparable participating employees. Comparable participating employees are eligible individuals who are in the same category of employees (current full time, current part time, or former employees) and who have the same category of HDHP coverage (self only, self plus one, self plus two, or self plus three or more). If an employer fails to make comparable contributions to the HSAs of its employees during a calendar year, an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year is imposed on the employer.

The Act allows employers to exclude highly-compensated employees (as defined by the IRS) when determining whether its contributions to non-highly compensated employees are comparable. This change makes it possible for an employer to make greater HSA contributions to employees that are not considered highly compensated without failing to meet the comparable contribution requirement.

Distributions From Individual Retirement Plans to Fund an HSA

The Act allows individuals to make a once in a lifetime trustee-to-trustee transfer from some individual retirement plans to an HSA. Unlike transfers from an FSA or HRA, the amount transferred does apply toward the annual HSA contribution limit.

Effective Date of Changes in Law

The new rules apply to taxable years beginning on or after December 31, 2006.

Please Contact Us with any Questions.



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