

New Flexibility for Health Savings Accounts

The Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, will provide new flexibility for participants in health savings accounts (HSAs). These new rules will enable participants to build HSA balances more quickly and will make the transition into a high deductible health plan (HDHP) and HSA structure easier. Most of these changes are effective as of January 1, 2007.

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Higher Limits for HSA Contributions

The new law eliminates the rule that prevented individuals from contributing more than the deductible of their HDHP to their HSA each year. Now, the only dollar limitation on contributions to the HSA is the annual dollar cap (\$2,850 for single coverage and \$5,650 for family coverage in 2007). These amounts will continue to be adjusted for cost of living. The adjusted amounts for a year are now to be published earlier, by June 1 of the preceding year.

In addition, an individual who is covered by an HDHP during the last month of a year is treated as having been eligible for all prior months in that year. This means that individuals who enroll in HDHP coverage mid-year and become HSA eligible can now contribute the full yearly dollar amount to their HSA for their partial first year of eligibility. Previously, participants who became eligible mid-year would only be eligible to contribute a pro-rated amount. However, this higher limit for mid-year enrollees is conditioned on the individual's remaining HSA-eligible (with qualifying HDHP coverage) during the remainder of the plan year and an additional 12 months. If an individual does not remain HSA-eligible for this period, the amounts contributed in excess of what could have been contributed under the old rules must be included in income and subject to an additional 10% penalty (unless the failure to remain HSA eligible is due to disability or death).

This change simplifies the determination of the limits for HSA contributions and provides a greater ability for participants to make HSA contributions and build their account balances.

More Flexible Rules Limiting Impact of the FSA "Grace Period" on HSA Eligibility

The new law broadens the ability of individuals to participate in an HSA for a new plan year, if they have been participating in a flexible spending account plan (FSA)

with a grace period that allows reimbursement from prior year FSA amounts for expenses incurred in the new year. Now, these FSA participants can make contributions to an HSA during the grace period if:

1. The individual's FSA balance is zero at the end of the prior year, or
2. The individual makes a transfer from the FSA to the HSA of the entire balance of the FSA as of the end of the prior year. (The new law now permits this transfer on a one-time basis.)

Another option remains available to permit individuals who have a FSA balance during the grace period to contribute to an HSA during the grace period. This can be done if the FSA plan is drafted to limit reimbursements during the grace period to HSA qualifying expenses for those participants who would otherwise be eligible to contribute to an HSA.

Permitted Transfers from FSAs and HRAs into HSAs

Effective as of December 20, 2006, individuals can transfer amounts from a FSA or a health reimbursement arrangement (HRA) into their HSA. These transfers are permitted only on a one-time basis for each FSA or HRA of an individual through 2011. The transfers must be done by a direct transfer and cannot be paid to the individual and then contributed to the HSA.

The amounts transferred to HSAs from FSAs or HRAs do not count against the annual contribution limits. However, the maximum amount that can be transferred is the balance in the FSA or HRA as of September 21, 2006, or if less, the balance as of the date of the transfer.

The law conditions the tax-free transfer on the individual's remaining HSA-eligible (with qualifying HDHP coverage) for a 12-month period following the month the transfer is made. If an individual does not remain HSA-eligible for the 12-month period, the transferred amount is included in income and subject to an additional 10% penalty.

Plan sponsors are not required to permit these transfers and will need to weigh the benefits to participants of adding transferred amounts to their HSA balances against the costs of communicating and administering the transfers. Additional costs to the plan sponsor may also result if the amounts the participants transfer



to the HSA would have been unused and forfeited if they were not transferred to the HSA. If a plan sponsor wishes to permit these transfers, the FSA or HRA plan documents will need to reflect this.

Permitted Transfers from IRAs into HSAs

Individuals will now also be able to transfer balances from certain individual retirement accounts (IRAs) into HSAs. This does not apply to SEP or SIMPLE IRAs.

Unlike the FSA or HRA transfers, IRA transfers count against the HSA contribution limits for the year. Like FSA and HRA transfers, the IRA transfers must be done by direct transfer and are subject to the potential tax and 10% penalty if the individual does not remain HSA eligible for the 12-month period. This transfer opportunity is available through 2011.

Greater Employer Contributions to HSAs Permitted for Non-Highly Compensated Employees

The HSA rules provide that if an employer provides contributions to employees' HSAs, the contributions must meet strict comparability rules (with a few limited exceptions such as collectively bargained employees). The new law now permits employers to make greater HSA contributions to non-highly compensated employees than for highly compensated employees without violating the comparability rules.

The exception from the comparability rules for qualifying employer contributions to HSAs through a cafeteria plan remains in effect. These contributions continue to be subject to the cafeteria plan discrimination rules and not the HSA comparability rules.

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