

December 2006 — Issue No. 91

Health Savings Account Legislation Makes HSAs More Flexible

Congress has passed significant changes to the laws governing Health Savings Accounts (HSAs) that should make HSAs more attractive to employees. President Bush is expected to sign the bill that includes these changes later this week. The HSA changes will make HSAs more flexible and will allow eligible individuals to set aside larger amounts than they have been able to previously.

The effective dates of the changes generally mean that the HSA improvements can be made available in 2007. To assist employers with early implementation, a Treasury Department representative has indicated that guidance on the changes will be provided shortly after the bill is signed. As those events play out, Willis will provide updates.

In this Alert, we provide a summary of the changes.

Annual HSA Contributions May Exceed HDHP Annual Deductible

Under the current rule, HSA contributions for a year cannot exceed the annual deductible under the high deductible health plan (HDHP) or, if less, the statutory limit (in 2007 that is \$2,850 for individual coverage and \$5,650 for family coverage). Many HDHPs have deductibles well below the statutory limits, so the amount that can be contributed to an HSA each year is smaller than it otherwise could be. The HSA changes eliminate the tie to the deductible under the HDHP, so that only the statutory dollar limit (\$2,850/\$5,650 for 2007) continues to apply. In most cases, this change will significantly increase the amounts that individuals can set aside in their HSAs, increasing HSAs' potential as retirement savings vehicles. This change is effective for tax years starting after December 31, 2006.

Employers should review their materials regarding HSA contributions promptly to ensure that this change does not result in the employer promising to contribute more than intended. For example, if an employer offered an HDHP with a \$1,500 individual annual deductible for 2007 and promised to contribute to each HDHP participant's HSA "the maximum amount allowed by law," the employer's HSA contribution for 2007 would have been \$1,500 before these changes, which will increase to \$2,850 in 2007. To prevent the promised 2007 HSA contribution from increasing to \$2,850, the employer will need to revise its materials.

FSA And HRA Rollovers To Fund HSAs.

Many employers desired to permit rollovers of participating employees' health Flexible Spending Arrangement ("FSA")

balances and Health Reimbursement Arrangement ("HRA") balances into the employees' HSAs. In most cases, participating in an FSA or HRA will make an employee ineligible to receive HSA contributions, so it is desirable to eliminate participation in both types of accounts. However, most employers are reluctant to force forfeitures of unused FSA and HRA balances (or in the case of HRAs, letting the balances be carried forward indefinitely). The ideal solution would be to transfer unused FSA and HRA balances into the individual's HSA, but the laws governing HSAs did not permit such rollovers.

The new bill would permit a one-time rollover from an FSA and a one-time rollover from an HRA into an individual's HSA in certain circumstances. Among other things, the contribution must be made directly by the employer before January 1, 2012 and must be no larger than the account balance as of September 21, 2006 (or the balance as of the distribution date, if less). This change to the HSA rules will permit rollovers as soon as the bill is signed. Guidance is needed to determine whether rules governing FSAs and HRAs limit the ability to make rollover distributions from those arrangements.

Relief from HSA Ineligibility Due to Participation in an FSA with a Grace Period.

Under IRS guidance from 2005, FSAs may adopt a grace period provision that allows participants up to an additional 2½ months after the end of a plan year to use up any FSA balance remaining unused at year-end. Currently, anyone who was an FSA participant at year-end is ineligible for HSA contributions during the three months that include the grace period. (See *Willis*

Employee Benefits Alert # 37 for information on the cafeteria plan grace period.) Unfortunately, this is true even if the FSA had a zero balance at year-end and throughout the grace period.

The HSA changes revise this rule so that an individual whose FSA balance is zero at year-end remains eligible for HSA contributions even if the FSA has a grace period. In addition, an individual whose year-end balance is not zero, but who is rolling that balance over into an HSA as described above, also remains eligible for HSA contributions during the grace period. These changes are effective as soon as the bill is signed. (See the discussion of partial year eligibility below for additional flexibility for individuals who are ineligible for HSA contributions due to the grace period despite the relief provided by this rule.)

Comparability Rules Permit Discrimination in Favor of Lower-Paid Employees

Current rules generally require that if an employer makes contributions to an HSA for any of its employees, a comparable amount must be contributed for all of its employees. That means that the employer cannot discriminate in favor of higher-paid employees, which makes sense and comports with the other nondiscrimination provisions in the IRC. However, it also means that employers cannot discriminate in favor of LOWER-paid employees either. The new provision would eliminate that anomaly starting with taxable years beginning after December 31, 2006 for employers who desire to make a change to their funding policies.

Cost of Living Adjustments To Be Announced Earlier in the Year

Several key dollar amounts concerning HSAs are tied to cost-of-living indices, and potentially change each year. These include the minimum annual deductible and maximum out-of-pocket limit for an HDHP and the HSA contribution limits. It has been a particular sore spot for employers and their advisors that the annually adjusted amounts are not announced until quite late into the year (it was November this year, see *Willis Employee Benefits Alert #87*). Many employers and advisers will cheer the HSA change that requires the IRS to publish the annually adjusted amounts no later than June 1 for the following calendar year.

Full Year's HSA Contribution for Partial Year's HSA Eligibility.

Current law requires that the HSA contributions be computed monthly based on an individual's eligibility for HSA contributions on the first day of each month. If an individual is not eligible for HSA contributions for a month, then the individual's annual HSA contribution limit is reduced by 1/12 for each month of ineligibility. The HSA changes provide, however, that an individual who meets all of the requirements to be eligible for HSA contributions during the last month of the year, is eligible for the full annual HSA contribution for that year in certain circumstances. This change is effective for taxable years beginning after December 31, 2006.

Distributions from IRAs to Fund HSAs

Currently, distributions from IRAs are treated as taxable distributions. However, the legislation will permit a one-time transfer from an IRA to an HSA in certain circumstances. Provided that the plan is not an SEP or a simple IRA, the IRA owner can make a one-time rollover, up to the annual HSA contribution limit from an IRA to an HSA. Because both IRAs and HSAs are individually owned accounts, this provision is likely to have little effect on employers.

Conclusion

These HSA changes are complex but greatly increase HSAs' flexibility and retirement savings potential. Treasury representatives have implied that, once the President has signed the bill, guidance on these changes will be out in time for employers to act on them before January 1, 2007. While it is advisable to review materials regarding HSA contributions before year-end to ensure that they do not inadvertently promise more than intended, we believe that employers should take a more measured approach to implementing others of these changes.

U.S. Benefit Office Locations

Anchorage, AK (907) 562-2266	Atlanta, GA (404) 224-5000	Austin, TX (800) 861-9851	Baltimore, MD (410) 527-1200
Birmingham, AL (205) 871-3871	Boise, ID (208) 340-0645	Boston, MA (617) 437-6900	Cary, NC (919) 459-3000
Charlotte, NC (704) 376-9161	Chicago, IL (312) 621-4700	Cincinnati, OH (513) 762-7661	Cleveland, OH (216) 861-9100
Columbus, OH (614) 766-8900	Dallas, TX (972) 385-9800	Denver, CO (303) 218-4020	Detroit, MI (248) 735-7580
Eugene, OR (541) 687-2222	Farmington, CT (860) 284-6137	Florham Park, NJ (973) 410-1022	Ft. Worth, TX (817) 335-2115
Grand Rapids, MI (616) 437-9864	Greenville, SC (864) 232-9999	Houston, TX (713) 625-1023	Jacksonville, FL (904) 355-4600
Knoxville, TN (865) 588-8101	Las Vegas, NV (702) 562-4335	Long Island, NY (516) 941-0260	Los Angeles, CA (213) 607-6300
Louisville, KY (502) 499-1891	Memphis, TN (901) 248-3100	Miami, FL (305) 373-8460	Milwaukee, WI (414) 271-9800
Minneapolis, MN (763) 302-7100	Mobile, AL (251) 433-0441	Mountain View, CA (650) 944-7000	Naples, FL (239) 514-2542
Nashville, TN (615) 872-3700	New Orleans, LA (504) 581-6151	New York, NY (212) 344-8888	Omaha, NE (402) 778-4851
Orlando, FL (407) 805-3005	Philadelphia, PA (610) 964-8700	Phoenix, AZ (602) 787-6000	Pittsburgh, PA (412) 586-1400
Portland, OR (503) 224-4155	Roswell, NM (505) 317-3397	St. Louis, MO (314) 721-8400	San Diego, CA (858) 678-2000
San Francisco, CA (415) 981-0600	San Juan, PR (787) 725-5880	Seattle, WA (206) 386-7400	Spokane, WA (206) 386-7400
Tampa, FL (813) 281-2095	Washington, DC (301) 530-5050	Wilmington, DE (302) 477-9640	

Willis Employee Benefits Alert is produced by Willis' Legal & Research Group. The information contained in this publication is not intended to represent legal advice and has been prepared solely for educational purposes. You may wish to consult your attorney regarding issues raised in this publication. Willis publications appear on the Internet at: www.willis.com © Copyright 2006