

**HSA Legislation  
Tax Relief & Healthcare Act of 2006  
Passed December 20, 2006  
Clarifications & Examples**

The following is a general overview of the recent legislative changes to HDHPs and HSAs. It also includes the annual minimums, maximums and contribution limits. This should be used for informational purposes only and should not be construed as tax advice. For more information, please contact your tax consultant.

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**#1 – Increased Annual Contribution Limit**

***Old Law***

HSA contributions were limited to the lesser of the statutory limits (\$2,850/\$5,650 for 2007) or the annual deductible, whichever was less.

***New Law***

The limit related to the plan's deductible has been eliminated. In 2008, any individual with HDHP coverage may make contributions up to the statutory limit which is \$2,900 for individuals and \$5,800 for families for 2008.

***Other Clarifications***

Participants can make greater contributions to their HSAs. The change gives greater flexibility to those that save and want to accumulate balances in their HSA. More money in the HSA will also reduce the risk that a person might exhaust HSA dollars before reaching the out of pocket maximum.

***Example***

Sally has self-only coverage in an HDHP with a deductible of \$1,200. With the new legislation, Sally may contribute up to \$2,850 in 2007 and \$2,900 in 2008.

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**#2 - Contribution Rules for Mid-year Enrollees**

***Old Law***

If an individual became eligible to contribute to an HSA anytime after the beginning of a calendar year, their HSA contribution was limited to a pro-rated amount of the annual dollar limit over the period of time during the calendar year they had HDHP coverage.

***New Law***

An individual that joins an HDHP during the year will be entitled to a full-year HSA contribution, provided they maintain HDHP coverage for what the Treasury calls the Deeming Rule. This means the individual must stay on an HSA-qualified plan for the remainder of the calendar year they made the full contribution as well as the entire next calendar year.

***Other Clarifications***

The change eliminates the complicated computation that was required to determine an individual's maximum HSA contribution when signing up for HDHP coverage in the middle of a calendar year. For example: Assume an employer has a calendar year health insurance plan. A new employee becomes eligible and signs up for individual HDHP coverage in July 2007. Even though they may not have had HDHP insurance coverage for the first 6 months of the year, they are eligible to make the full-year HSA contribution (\$2,850 for 2007 & \$2,900 for

2008), provided they have the HDHP for the Deeming Rule period. This means they must have the plan for the remainder of 2007 through December 31, 2008.

If the individual is not eligible for the Deeming Rule period, the contribution amounts attributable to the months preceding the month in which the individual became HSA-eligible are includible in income and subject to the 10% additional tax.

Note that the participant is only subject to the deeming rule if they contribute the maximum. If they leave their employer, go on Medicare or drop the plan, they would just need to prorate their contribution for the number of months that they were eligible to contribute. As long as all of this is worked out before they file their taxes or by April 15, they are not subject to penalties.

### ***Example***

Mark works at an employer whose benefit and tax year is January through December. On December 1, 2007, Mark enrolls in an HDHP and is eligible and opens an HSA. Taking advantage of the new provision, he contributes the full \$2,850 (in 2007) to the HSA. In June 2008, Mark decides that he is no longer keeping his HDHP coverage. A portion of his HSA contribution from December 2007 should now be included in gross income and be subject to 10% tax. That amount is \$2,612.50, which is \$2,850 (amount of his contribution) minus \$237.50 (one month prorated amount for December 2007, his only month of eligibility).

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## **#3 – HRA & FSA Rollover to HSA**

### ***Old Law***

There was no mechanism for transferring amounts from a flexible spending account (FSA) or a health reimbursement arrangement (HRA) to an HSA.

### ***New Law***

A 5-year window (ending 12/31/2011) will permit an employer to make a one-time transfer from a health FSA or HRA to an employee's HSA. The following limitations apply:

- The amount transferred cannot exceed the balance in the FSA or HRA as of 9/21/06
- If offered by employer, they must be available to all participants
- The individual that makes the transfer under the new law must remain HSA-eligible for 13 Months. Otherwise they will incur taxes and a 10% penalty on the amount of the transfer
- Does not Count as Plan Contribution

### ***Clarifications***

The transfer is treated as a rollover, and therefore, will not count as a plan contribution in the year it is made.

Under the guidance, a health FSA with a grace period or HRA must be amended and a rollover selected by an employee before year-end. The balance amount must be transferred to the HSA by March 15 of the following year. The ability to make these transfers will facilitate the transition to an HSA-eligible health plan when employees are covered by an HRA or FSA.

For 2006, election and transfer must take place by March 15, 2007.

An employer that previously sponsored an HRA and now would like to adopt an HSA can allow participants to transfer HRA balances to the new arrangement.

Participants that have health FSA balances may transfer the remainder of the balances in the year they first decide to go into an HSA.

Because this is a one-time transfer it will not offer much relief from the consequences of the use it of lose it rule.

The employer controls access to this transfer. Before a transfer can occur, the employer must amend its HRA or health FSA plan document to permit this transfer. Since HRA and FSA arrangements are health benefit plans that are typically paid for and controlled by the employer, the employer should weigh the cost of permitting this type of transfer before changing its plans.

**Example**

John had an HRA on September 21, 2006 with a balance of \$752. His employer has modified the HRA plan to allow HRA transfers to an HSA. On February 15, 2007 John decides that he wants to make a distribution from his HRA to his HSA. He currently has \$926 in his HRA. The maximum amount that he can contribute to his HSA is \$752. It is based on the balance as of September 21, 2006.

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**#4 - FSA Grace Period**

**Old Law**

In 2005, the IRS began allowing a 2-½ month grace period for participants to incur claims against their health FSA balances. However, IRS Notice 2005-86 provided that if a plan permitted the grace period, then the participant was considered to have “other coverage” for the purpose of determining eligibility to make HSA contributions. This was true even if the participant had already spent their entire health FSA balance before the calendar year in which the HSA eligibility was being determined.

**New Law**

If the participant starts the year with zero balance remaining in their health FSA, or if they transfer their health FSA balance to an HSA, then the grace period coverage will not impact the participant’s ability to make an HSA contribution.

**Other Clarifications**

This provision overrides the result in IRS Notice 2005-86 and eliminates the negative consequences to those employers that wanted to permit the grace period feature in their health FSA plans.

**Example**

Bob has an FSA whose plan year is January through December 2007. On December 31, 2007, Bob has a balance of \$0 in his general purpose FSA. His employer has opted for the 2-½ month grace period. Bob enrolls in an HSA-qualified HDHP effective January 1, 2008. Under original HSA guidelines, Bob could not be contributing to his HSA until April 1, 2008 as he had non-permitted coverage in January through March with the FSA. With the new legislation, Bob can begin contributing to his opened HSA on January 1, 2008.

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**#5 - IRA Rollover to an HSA**

**Old Law**

Rollovers from an IRA to an HSA were not permitted

### ***New Law***

A one time tax-free rollover from an IRA to an HSA is now permitted. The amount of the rollover counts against the individual's HSA contribution limit in the year the rollover is made. If the individual fails to maintain HSA eligibility for a period of 13 months following the rollover, they will be subject to income tax and a 10% penalty on the amount of the transfer.

### ***Other Clarifications***

This provision will help a participant that wants to get a jump-start on funding their HSA.

There is no additional tax deduction for money being transferred from an IRA to an HSA, so initially; this transaction is not a tax break. However, the participant would not pay taxes on qualified distributions from the HSA.

### ***Example***

In March 2007, Jim has individual coverage under his HDHP and decides to contribute \$2,850 from his retirement account into his HSA. Since that is his maximum he can contribute to an HSA for 2007, he cannot make any other HSA contributions.

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## **#6 – Higher Employer Contribution Limits for Lower Paid Employees**

### ***Old Law***

Employer contributions to an HSA must be “comparable” for all participants, unless those contributions are run through the employer’s cafeteria plan.

### ***New Law***

An employer can make higher contributions to non-highly compensated employees.

### ***Other Clarifications***

Employers that would like to encourage HSA use can give larger employer contributions to non-highly compensated employees.

This exception to the comparability rules will help employers that do not currently run HSA contributions through a cafeteria plan.

Highly Compensated Employees are defined under Code section 414(q), which generally means that individuals who earn less than \$100,000 (for 2007) will be considered Non-Highly Compensated Employees.

### ***Example***

Marcy is the CEO of a manufacturing company with 400 non-highly compensated employees (NHCEs) and 100 highly compensated employees (HCEs). The 400 NHCEs are employees who do not meet the following criteria:

- Was a 5% owner at any time during the year or the preceding year
- Had compensation from the employer in the preceding year in excess of \$100,000 (for 2007) or if elected by the employer, was in the group consisting of the top 20% of employees when ranked based on compensation.

She can now put \$50 more a month into the lower paid employees’ HSAs without violating non-discrimination testing.

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## **#7 - Cost-of-Living Adjustments to be Released Earlier in the Year**

### **Old Law**

HSA limits were based on annual cost of living factors that could not be determined until late in the year, typically around early November.

### **New Law**

The Tax Code provisions have been changed requiring the indexed limits to be computed and released by June 1.

### **Clarifications**

Prior to this change, an employer's task in designing and communicating an HSA arrangement was difficult because no one knew what the HSA and HDHP limits were going to be until November. This change should solve that problem and give employers time to design and communicate information about their health plans.

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## **Employer Advantages**

Increased payroll savings

- Since employees can contribute more to their HSAs, that translates to increased payroll savings for the employer

Increased uptake in HSA options

- More flexibility in contributions and rollovers mean more employees will want to enroll in the HSA option

Increased buy-in to CDH ideals lowers healthcare usage

- Employees that aim to grow their HSA balance are more likely to live a healthy lifestyle

Ability to contribute different amounts to different types of employees

- Contribute a higher percentage to non-highly compensated employees

More time to plan for contribution limit changes

- An employer can finalize their benefit design early in 2007

## **Employer Checklist**

Decide on whether to allow FSA or HRA funds transfer

- Contact account administrator to initiate
- Alert employees to additional benefit and process

Review your HSA contribution levels

- Decide whether to increase contribution levels for NHCEs
- Review contribution levels to all employees

Communications

- Communicate the new limits and regulations to all employees (new limits may drive future HDHP enrollment)
- Instruct employees on process to increase HSA contributions
- Alert employees to any changes you make to benefits
- Update plan documents, benefit guides and corporate intranet

## HDHP/HSA Legislation Requirements Minimums, Maximums & Contributions Limits

	2004	2005	2006	2007	2008	2009	2010
<b>HDHP Limits</b>							
Individual Deductible Minimum	\$1,000	\$1,000	\$1,050	\$1,100	\$1,100	\$1,150	\$1,200
Family Deductible Minimum	\$2,000	\$2,000	\$2,100	\$2,200	\$2,200	\$2,300	\$2,400
Maximum Individual OOP	\$5,000	\$5,000	\$5,250	\$5,500	\$5,600	\$5,800	\$5,950
Maximum Family OOP	\$10,000	\$10,000	\$10,500	\$11,000	\$11,200	\$11,600	\$11,900
<b>HSA Contribution Limits</b>							
Maximum Annual Individual Contribution	\$2,600	\$2,600	\$2,700	\$2,850	\$2,900	\$3,000	\$3,050
Maximum Annual Family Contribution	\$5,150	\$5,150	\$5,450	\$5,650	\$5,800	\$5,950	\$6,150
55+ Annual Catch Up Contribution	\$500	\$600	\$700	\$800	\$900	\$1,000	\$1,000