

## December 2006 LEGAL ALERT Notice:

### New Law Enhances HSAs

A new law will make Health Savings Accounts (HSAs) available to more taxpayers, allow certain tax-free transfers from health care spending, IRAs and other accounts to HSAs and ease some of the discrimination standards imposed on employers. These changes are part of the \$50 billion Tax Relief and Health Care Act of 2006 passed in the final moments of the 109th Congress. The President is expected to sign the Act shortly.

HSAs first became available to taxpayers in 2004 as part of Congress's attempt to expand health care coverage and control costs through consumer-directed programs. HSAs are tax-favored investment accounts that may be used to pay for an individual's current or future health, vision and dental expenses. To set up an HSA, an individual must be covered by a "high deductible health plan" (HDHP) and satisfy certain other eligibility rules. Within the statutory limits, employer contributions to an HSA are not taxable, and the individual may make tax-deductible contributions to the HSA. Employers have been slow to adopt HSAs and, among those that have, employees have been reluctant to enroll. The enhancements added by Congress, some effective immediately, are an attempt to encourage the growth of HSAs.

#### **HSA ENHANCEMENTS**

#### **ROLLOVERS ALLOWED FROM HEALTH FSAs, HRAs, AND IRAs INTO HSAs FOR A LIMITED TIME**

#### **ROLLOVER FROM FSA OR HRA**

The Act allows employers to permit participants to transfer, tax-free, their balances in health flexible spending accounts (FSAs) and/or health reimbursement arrangements (HRAs) into an HSA. The transfer is limited to the lesser of the balance in the health FSA or HRA as of September 21, 2006, or the balance as of the date of distribution. The provision is

limited to one transfer with respect to each health FSA or HRA of the individual. Employers must not discriminate under this provision --if the employer allows any employee to transfer balances, then all employees covered under a high deductible plan of the employer must be allowed to do so.

The rollovers are intended to assist individuals in switching to a high deductible health plan. Therefore, if an individual transfers funds from an FSA or HRA into an HSA, they must remain eligible for the high deductible plan for at least 12 full months following the first month that a transfer is made.

This provision is effective for transfers on or after the date of enactment and before January 1, 2012.

#### **ROLLOVER FROM IRA**

This provision permits a one-time trustee-to-trustee transfer of funds from an individual retirement arrangement (IRA) to an HSA. The transfer is tax-free and not subject to the 10 percent additional tax on early distributions. If an individual makes a transfer from an IRA to an HSA, the annual amount he or she can contribute to the HSA is reduced by the amount transferred from the IRA. Only one transfer per individual is permitted, unless the transfer is made during a month when an individual has self-only coverage, in which case an additional transfer may be made during a subsequent month within the taxable year in which the individual has family coverage.

The rollover amount will be included in gross income and subject to the 10 percent excise tax if the individual ceases to be eligible for the high deductible health plan during the testing period (which starts with the month of the rollover and ends on the last day of the twelfth month following that month).

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This provision is effective for taxable years beginning in 2007.

## **FSA GRACE PERIOD MAY NOT PREVENT HSA ELIGIBILITY**

The Act eases the transition for employees moving to an HSA who were covered in a health care flexible spending account ("FSA"). Generally, an individual may not participate in both an HSA and an FSA because FSA coverage is not a high deductible health plan. According to the IRS, this restriction continues during any "grace period" after the end of the plan year during which unused FSA amounts are available to pay new medical expenses, even if there was no money left in the FSA. Under the new law, individuals with a zero balance in their FSA at yearend may contribute to an HSA at the start of the new year. Also, an individual with funds remaining in his or her FSA may transfer the FSA balance into an HSA on a tax-free basis.

This provision is effective for taxable years beginning in 2007.

## **REPEAL OF ANNUAL PLAN DEDUCTION LIMITATIONS ON HSA CONTRIBUTION LIMITATION**

Prior to this Act, an individual's maximum contribution towards their HSA was tied to that plan's annual deductible. This provision removes that limitation and sets a maximum aggregate annual contribution to HSAs of \$2,850 for individuals and \$5,650 for family coverage in 2007.

This provision is effective for taxable years beginning in 2007.

## **EARLIER NOTICE OF COST OF LIVING ADJUSTMENTS**

The Treasury Department will make future cost of living adjustments to the contribution limits and HDHP requirements by June 1st of the preceding year.

This provision is effective for taxable years beginning in 2008.

## **FULL-YEAR CONTRIBUTION ALLOWED FOR MID-YEAR ENROLLEES**

This provision allows individuals who first enroll in a high deductible plan after the start of the year to make a full HSA contribution for the year. However, if the individual does not remain eligible for the highdeductible plan during the testing period (the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month), then an amount equal to the HSA deduction during the period that the individual was treated as eligible is included in income, and an additional 10% tax applies to the amount includable.

This provision is effective for taxable years beginning in 2007.

## **EMPLOYERS MAY MAKE LARGER CONTRIBUTIONS FOR NHCES**

Employers will now be permitted to make larger HSA contributions for non-highly compensated employees (NHCEs) than for highly compensated employees (HCEs). Basically, for 2007, an employee is an NHCE if he or she earned less than \$100,000 in 2006. If an employer makes a contribution for one NHCE, the employer must make comparable contributions on behalf of all NHCEs with comparable coverage during the same period.

This provision is effective for taxable years beginning in 2007.

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This update is brought to you by C.M. Smith Agency, Inc.

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