



The "New Improved" HSA After the Tax Relief and Health Care Act of 2006



Podcast of February 3, 2007

Feed address for Podcast subscription:

<http://feeds.feedburner.com/EdZollarsTaxUpdate>

Home page for Podcast: <http://ezollars.libsyn.com>

©2007 Edward K. Zollars, CPA

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.

HSAs and the Tax Relief and Health Care Act of 2006

A number of provisions were included in the Tax Relief and Health Care Act of 2006 that affected Health Savings Accounts (HSAs). We'll take a look at these provisions in a bit more detail this week.

○ FSA and HRA Funds Can Be Used to Fund HSAs (Act Sec. 302(a))

The bill contained the following provision:

(a) IN GENERAL.--Section 106 (relating to contributions by employer to accident and health plans) is amended by adding at the end the following new subsection:

"(e) FSA AND HRA TERMINATIONS TO FUND HSAs.--

"(1) IN GENERAL.--A plan shall not fail to be treated as a health flexible spending arrangement or health reimbursement arrangement under this section or section 105 merely because such plan provides for a qualified HSA distribution.

"(2) QUALIFIED HSA DISTRIBUTION.--The term 'qualified HSA distribution' means a distribution from a health flexible spending arrangement or health reimbursement arrangement to the extent that such distribution--

"(A) does not exceed the lesser of the balance in such arrangement on September 21, 2006, or as of the date of such distribution, and

"(B) is contributed by the employer directly to the health savings account of the employee before January 1, 2012.

Such term shall not include more than 1 distribution with respect to any arrangement.

"(3) ADDITIONAL TAX FOR FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE.--

"(A) IN GENERAL.--If, at any time during the testing period, the employee is not an eligible individual, then the amount of the qualified HSA distribution--

"(i) shall be includible in the gross income of the employee for the taxable year in which occurs the first month in the testing period for which such employee is not an eligible individual, and

"(ii) the tax imposed by this chapter for such taxable year on the employee shall be increased by 10 percent of the amount which is so includible.

"(B) EXCEPTION FOR DISABILITY OR DEATH.--Clauses (i) and (ii) of subparagraph (A) shall not apply if the employee ceases to be an eligible individual by reason of the death of the employee or the employee becoming disabled (within the meaning of section 72(m)(7)).

"(4) DEFINITIONS AND SPECIAL RULES.--For purposes of this subsection--

"(A) TESTING PERIOD.--The term 'testing period' means the period beginning with the month in which the qualified HSA distribution is contributed to the health savings account and ending on the last day of the 12th month following such month.

"(B) ELIGIBLE INDIVIDUAL.--The term 'eligible individual' has the meaning given such term by section 223(c)(1).

"(C) TREATMENT AS ROLLOVER CONTRIBUTION.--A qualified HSA

distribution shall be treated as a rollover contribution described in section 223(f)(5).

"(5) TAX TREATMENT RELATING TO DISTRIBUTIONS.--For purposes of this title--

"(A) IN GENERAL.--A qualified HSA distribution shall be treated as a payment described in subsection (d).

"(B) COMPARABILITY EXCISE TAX.--

"(i) IN GENERAL.--Except as provided in clause (ii), section 4980G shall not apply to qualified HSA distributions.

"(ii) FAILURE TO OFFER TO ALL EMPLOYEES.--In the case of a qualified HSA distribution to any employee, the failure to offer such distribution to any eligible individual covered under a high deductible health plan of the employer shall (notwithstanding section 4980G(d)) be treated for purposes of section 4980G as a failure to meet the requirements of section 4980G(b)."

An employer's FSA or HRA plan can allow for unused funds to be rolled into an HSA for the employee in certain circumstances. The amount rolled into the HSA is limited to the lesser of

- The employee's balance in the FSA or HRA on September 21, 2006 or
- The balance in the account on the date of the distribution.

The amount must be transferred before January 1, 2012 and limited to only a single distribution per arrangement.

The employee must remain an "eligible individual" under the HSA rules for the 12 month period following the rollover into the account by the employer or face inclusion of the rollover in the employee's income along with a 10% increase in the tax otherwise due on the distribution.

○ **Certain FSA Balances Ignored in Determining Disqualified Coverage (Act Sec. 302(b))**

New law addition:

(b) CERTAIN FSA COVERAGE DISREGARDED COVERAGE.--Subparagraph (B) of section 223(c)(1) (relating to certain coverage disregarded) is amended by striking "and" at the end of clause (i), by striking the period at the end of clause (ii) and inserting ", and", and by inserting after clause (ii) the following new clause:

"(iii) for taxable years beginning after December 31, 2006, coverage under a health flexible spending arrangement during any period immediately following the end of a plan year of such arrangement during which unused benefits or contributions remaining at the end of such plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during such period if--

"(I) the balance in such arrangement at the end of such plan year is zero, or

"(II) the individual is making a qualified HSA distribution (as defined in section 106(e)) in an amount equal to the remaining balance in such arrangement as of the end of such plan year, in accordance with rules prescribed by the Secretary."

For 2007 and later years, an individual can ignore certain FSA coverage in determining if the individual has disqualifying coverage. The provision addresses the problem caused by the IRS liberalization of the "use it or lose it" provision for cafeteria plans, which allowed a short term carryover of balances unused at year end. Plans that provided such coverage were deemed to "taint" all participants in the FSA for the prior year, including those with no balance at the end of the year.

The law amends §223(c)(1) to allow an individual to ignore such coverage if one of two tests is met. The individual must either:

- Have a zero balance in the FSA arrangement as of the end of the previous year or
- The individual makes a qualifying HSA distribution pursuant to the provision discussed above for the balance in the account as of the end of the prior year

Note that this will not solve all problems—if an individual actually makes use of any of the funds remaining in the FSA account after year end to pay for expenses, the entire period would become tainted—the rules don't allow an employee to zero the account out in January. And, of course, in order to make a qualified HSA distribution the employer's plan has to provide for such an option.

○HSA Contributions No Longer Capped at the Amount of the Deductible (Act Sec. 303)

A more interesting change from a financial planning standpoint is found in the following provision:

SEC. 303. REPEAL OF ANNUAL DEDUCTIBLE LIMITATION ON HSA CONTRIBUTIONS.

(a) IN GENERAL.--Paragraph (2) of section 223(b) (relating to monthly limitation) is amended--

(1) in subparagraph (A) by striking "the lesser of--" and all that follows and

inserting "\$2,250.", and

(2) in subparagraph (B) by striking "the lesser of--" and all that follows and inserting "\$4,500."

(b) CONFORMING AMENDMENT.--Section 223(d)(1)(A)(ii)(I) is amended by striking "subsection (b)(2)(B)(ii)" and inserting "subsection (b)(2)(B)".

(c) EFFECTIVE DATE.--The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

For 2007 and later years, HSA contributions are no longer limited to the lesser of the statutory maximum figure or the actual deductible amount under the high deductible health plan. Rather, only the statutory maximum figures apply. For 2007 those figures are \$2,850 for self-only coverage and \$5,650 for family coverage.

The health insurance coverage will still need to have at least the minimum deductible allowed for HDHP plans (\$1,100 for an individual and \$2,200 for family only coverage) and must otherwise meet the HDHP requirements.

○ **Contribution Limit Not Reduced for Part Year Coverage (Act Sec. 305)**

Congress looked at dealing with what some might have seen as a disincentive to starting an HSA later in the year by making the following change:

SEC. 305. CONTRIBUTION LIMITATION NOT REDUCED FOR PART-YEAR COVERAGE.

(a) INCREASE IN LIMIT FOR INDIVIDUALS BECOMING ELIGIBLE INDIVIDUALS AFTER BEGINNING OF THE YEAR.--Subsection (b) of section 223 (relating to limitations) is amended by adding at the end the following new paragraph:

"(8) INCREASE IN LIMIT FOR INDIVIDUALS BECOMING ELIGIBLE INDIVIDUALS AFTER THE BEGINNING OF THE YEAR.--

"(A) IN GENERAL.--For purposes of computing the limitation under paragraph (1) for any taxable year, an individual who is an eligible individual during the last month of such taxable year shall be treated--

"(i) as having been an eligible individual during each of the months in such taxable year, and

"(ii) as having been enrolled, during each of the months such individual is treated as an eligible individual solely by reason of clause (i), in the same high deductible

health plan in which the individual was enrolled for the last month of such taxable year.

"(B) FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE.--

"(i) IN GENERAL.--If, at any time during the testing period, the individual is not an eligible individual, then--

"(I) gross income of the individual for the taxable year in which occurs the first month in the testing period for which such individual is not an eligible individual is increased by the aggregate amount of all contributions to the health savings account of the individual which could not have been made but for subparagraph (A), and

"(II) the tax imposed by this chapter for any taxable year on the individual shall be increased by 10 percent of the amount of such increase.

"(ii) EXCEPTION FOR DISABILITY OR DEATH.--Subclauses (I) and (II) of clause (i) shall not apply if the individual ceased to be an eligible individual by reason of the death of the individual or the individual becoming disabled (within the meaning of section 72(m)(7)).

"(iii) TESTING PERIOD.--The term 'testing period' means the period beginning with the last month of the taxable year referred to in subparagraph (A) and ending on the last day of the 12th month following such month."

(b) EFFECTIVE DATE.--The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

Effective beginning in 2007, individuals will not have their maximum HSA contribution reduced in the first year they establish the HSA due to nonqualifying coverage they had earlier in the year so long as they stay HSA eligible for 12 months following the end of the prior year.

If that coverage is not maintained, the individual will pay tax on the amount that would not have been allowed as a contribution to the HSA in the prior year plus a 10% addition to tax.

○ **Comparability Rules Relaxed to Allow Higher Contributions for Non-Highly Compensated Employees (Act Sec. 306)**

One of the major disincentives for using HSAs fully in an employment setting has been the comparability rules that are invoked if the employer makes contributions to employees' HSAs. Congress has offered a very limited liberalization in this area.

SEC. 306. EXCEPTION TO REQUIREMENT FOR EMPLOYERS TO MAKE COMPARABLE HEALTH SAVINGS ACCOUNT CONTRIBUTIONS.

(a) IN GENERAL.--Section 4980G (relating to failure of employer to make comparable health savings account contributions) is amended by adding at the end the following new subsection:

"(d) EXCEPTION.--For purposes of applying section 4980E to a contribution to a health savings account of an employee who is not a highly compensated employee (as defined in section 414(q)), highly compensated employees shall not be treated as comparable participating employees."

(b) EFFECTIVE DATE.--The amendment made by this section shall apply to taxable years beginning after December 31, 2006.

For purposes of determining if an excessive contribution has been made on behalf of a non-highly compensated employee (within the meaning of §414(q)), highly compensated employees shall not be treated as comparable participating employees. Thus, an employer could offer to pay the entire deductible of non-highly participating employees while paying nothing or a reduced amount for highly compensated employees. This provision is first effective for 2007.

○ Individuals Get a Once in a Lifetime Time Use of IRA Funds to Pay HRA Funding (Act Sec. 307)

Congress has decided to try and “jump start” establishment of HRAs by allowing taxpayers to take funds from their IRA to make one year’s contribution to their HRA.

SEC. 307. ONE-TIME DISTRIBUTION FROM INDIVIDUAL RETIREMENT PLANS TO FUND HSAs.

(a) IN GENERAL.--Subsection (d) of section 408 (relating to taxability of beneficiary of employees' trust) is amended by adding at the end the following new paragraph:

"(9) DISTRIBUTION FOR HEALTH SAVINGS ACCOUNT FUNDING.--

"(A) IN GENERAL.--In the case of an individual who is an eligible individual (as defined in section 223(c)) and who elects the application of this paragraph for a taxable year, gross income of the individual for the taxable year does not include a qualified HSA funding distribution to the extent such distribution is otherwise includible in gross income.

"(B) QUALIFIED HSA FUNDING DISTRIBUTION.--For purposes of this

paragraph, the term 'qualified HSA funding distribution' means a distribution from an individual retirement plan (other than a plan described in subsection (k) or (p)) of the employee to the extent that such distribution is contributed to the health savings account of the individual in a direct trustee-to-trustee transfer.

"(C) LIMITATIONS.--

"(i) MAXIMUM DOLLAR LIMITATION.--The amount excluded from gross income by subparagraph (A) shall not exceed the excess of--

"(I) the annual limitation under section 223(b) computed on the basis of the type of coverage under the high deductible health plan covering the individual at the time of the qualified HSA funding distribution, over

"(II) in the case of a distribution described in clause (ii)(II), the amount of the earlier qualified HSA funding distribution.

"(ii) ONE-TIME TRANSFER.--

"(I) IN GENERAL.--Except as provided in subclause (II), an individual may make an election under subparagraph (A) only for one qualified HSA funding distribution during the lifetime of the individual. Such an election, once made, shall be irrevocable.

"(II) CONVERSION FROM SELF-ONLY TO FAMILY COVERAGE.--If a qualified HSA funding distribution is made during a month in a taxable year during which an individual has self-only coverage under a high deductible health plan as of the first day of the month, the individual may elect to make an additional qualified HSA funding distribution during a subsequent month in such taxable year during which the individual has family coverage under a high deductible health plan as of the first day of the subsequent month.

"(D) FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE.--

"(i) IN GENERAL.--If, at any time during the testing period, the individual is not an eligible individual, then the aggregate amount of all contributions to the health savings account of the individual made under subparagraph (A)--

"(I) shall be includible in the gross income of the individual for the taxable year in which occurs the first month in the testing period for which such individual is not an eligible individual, and

"(II) the tax imposed by this chapter for any taxable year on the individual shall be increased by 10 percent of the amount which is so includible.

"(ii) EXCEPTION FOR DISABILITY OR DEATH.--Subclauses (I) and (II) of

clause (i) shall not apply if the individual ceased to be an eligible individual by reason of the death of the individual or the individual becoming disabled (within the meaning of section 72(m)(7)).

"(iii) TESTING PERIOD.--The term 'testing period' means the period beginning with the month in which the qualified HSA funding distribution is contributed to a health savings account and ending on the last day of the 12th month following such month.

"(E) APPLICATION OF SECTION 72.--Notwithstanding section 72, in determining the extent to which an amount is treated as otherwise includible in gross income for purposes of subparagraph (A), the aggregate amount distributed from an individual retirement plan shall be treated as includible in gross income to the extent that such amount does not exceed the aggregate amount which would have been so includible if all amounts from all individual retirement plans were distributed. Proper adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent taxable years."

(b) COORDINATION WITH LIMITATION ON CONTRIBUTIONS TO HSAs.--Section 223(b)(4) (relating to coordination with other contributions) is amended by striking "and" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", and", and by inserting after subparagraph (B) the following new subparagraph:

"(C) the aggregate amount contributed to health savings accounts of such individual for such taxable year under section 408(d)(9) (and such amount shall not be allowed as a deduction under subsection (a))."

(c) EFFECTIVE DATE.--The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

Individuals will be allowed a one time transfer from their IRAs to fund the amount that would otherwise have been their deductible HRA contribution for a year. The distribution from the IRA will not be includable in income, and the taxpayer will not get a deduction for the HSA funding. The individual must remain an "eligible individual" for HSA funding purposes for the 12 months beginning with the month the transfer is made. If the individual does not maintain that status, then the entire contribution will be included in the individual's income and also be subject to a 10% addition to tax.

Such distributions reduce the amount the individual otherwise would be allowed to contribute to their HSA for the year in question.