



## HSAs Slim Down for the New Year

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HSA rules, that is, get a make over to remove excess baggage. To help expand the use of Health Savings Accounts (HSAs) by individuals and families, the following seven provisions were part of the Tax Relief and Health Care Act of 2006 passed on December 9, 2006.

- The 2-1/2 month “grace period” that employer’s may tack on to the end of their Health Flexible Spending Account (Health FSA) plan will no longer delay eligibility to establish an HSA if:
  - The Health FSA balance is zero on the last day of the plan year; or
  - The individual is making a Qualified HSA Distribution in an amount equal to the remaining balance in the Health FSA as of the end of such plan year.

Formerly, employees caught with account balances in their Health FSA during this 2-1/2 month extended period of coverage were deemed to be covered by “other insurance” and not able to begin contributing to their HSA. They may now make a one-time distribution from their Health FSA in order to hasten participation in their HSA.

- One-time contribution to an HSA from a participant’s Health FSA or Health Reimbursement Arrangement (HRA). Called a Qualified HSA Distribution, this one-time distribution from a Health FSA or an HRA cannot exceed the lesser of the balance in the arrangement on September 21, 2006, or as of the date of such distribution. The Qualified HSA Distribution is required to be contributed by the employer directly into the participant’s HSA, and can be done at any time prior to January 1, 2012. Other rules surrounding this distribution include:
  - Requirement of participant to maintain a qualifying high-deductible health plan (HDHP) for a designated period of time. The participant must maintain an HDHP for a “testing period” that starts with the date of the distribution and ends on the last day of the 12th month following the distribution date. Otherwise, the amount of the Qualified HSA Distribution will be included in the gross income of the participant when they become ineligible to participate in an HSA. A 10% additional tax will also apply to the distribution amount.
  - The only exception to maintaining an HDHP during the testing period would be if the HSA account holder were to become disabled or die.
  - Qualified HSA Distributions will be treated as a rollover contribution. That means the distribution will not reduce the account holder’s annual contribution limit.
  - Funds contributed by the employer from either a participant’s Health FSA or HRA would not be used in applying the HSA comparability rules. However if one employee is offered the opportunity to roll their funds from one plan to another, the employer must offer all eligible individuals covered by an HDHP the opportunity for this distribution. The employer will be deemed as having failed the comparability rules by not following this rule.
- One-time distribution from an IRA to an HSA can be made via a direct trustee-to-trustee transfer. The IRA distribution, when added to other contributions for the taxable year, cannot exceed the HSA annual limitation for that year. Other rules surrounding this distribution include:

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- Requirement of participant to maintain a qualifying HDHP for a designated period of time. The participant must maintain an HDHP for a “testing period” that starts with the date of the distribution and ends on the last day of the 12th month following the distribution date. Otherwise, the amount of the transfer will be included in the gross income of the participant when they become ineligible to participate in an HSA. A 10% additional tax will also apply to the distribution amount.
- The only exception to maintaining an HDHP during the testing period would be if the HSA account holder were to become disabled or die.
- If the participant converts from self-only to family coverage, they may make an additional distribution from their IRA.

Making more people eligible, removing the “hassle factor,” and allowing transfer of funds from one type of plan to another add up to enhanced participation in HSAs.

The Health FSA or HRA fund transfer specifications are generally considered to be “termination transfers.” Employers who want to terminate their HRA, may now hand over each participant’s HRA cash equivalent to their respective HSA. Employer strategy may include dropping the HRA funding obligation, or encouraging employees to move to a higher deductible insurance product.

When would an employer or participant want to terminate a Health FSA? If the employer offers the 2-1/2 month “grace period.” In order to be eligible to set up and contribute to an HSA, the account holder may not be covered by any other health insurance. A Health FSA is considered other health coverage, and participants don’t want leftover funds in their Health FSA to disqualify their participation in an HSA.

- HSA participants may now contribute the annual limit to their HSA without regard to the deductible of their particular HDHP. That means participants with single coverage may contribute up to \$2,850 and those with family coverage have a limit of \$5,650 in 2007, even if they have an HDHP with a lower annual deductible amount.
- Allow participants to “fully fund” their HSAs even if they did not have an HDHP for every month during that taxable year. If participants are HSA eligible by the first day of December, they may contribute the full annual statutory limit for that year. For 2007, those limits are \$2,850 for account holders with single coverage and \$5,650 for those with family coverage. Other rules surrounding these contributions include:
  - Requirement of participant to maintain a qualifying HDHP for a designated period of time. The participant must maintain an HDHP for a “testing period” that starts with the last month of the applicable year and ending on the last day of the last month of the following year. Otherwise, the amount of the excess HSA contributions will be included in the gross income of the participant as of the date they become ineligible to participate in an HSA. A 10% additional tax will also apply to the distribution amount.
  - The only exception to maintaining an HDHP during the testing period would be if the HSA account holder were to become disabled or die.

Former legislation capped the maximum annual contribution to an HSA at the lesser of the HDHP deductible amount or the annual statutory limits, and only allowed contributions to an HSA for the months an account holder was covered by the qualifying HDHP.

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This means more money going into HSAs for current medical expenses with leftovers for retirement.

- Exception for employers to make comparable HSA contributions. Contributions made to non-highly compensated employees may be higher than to those considered highly compensated (as defined under IRC Section 414(q)) without regard to the comparability rules.

Employers have asked for this reverse discrimination. Higher deductible insurance plans, and increasing participation in HSAs can mean savings for employers.

- Cost-of-living adjustments (COLAs) will be released June 1 of every year for HSAs for taxable years beginning after 2007.

Release of HSA minimums and maximums earlier in the calendar year will ensure that plan sponsors and their employees have ample time to set up for the coming year. Plan design options can be weighed, and brochures and educational materials can be printed ahead of open enrollment

Over a year ago, Congressman Cantor stated, “The more people adopt HSAs for their health care coverage, the more market forces will work to reduce costs. That is why we must do all that we can to make HSAs available and attractive to individuals and families looking for health care coverage.” ■

### Plan Service Provider Tips

1. If an employer wants to institute the 2-1/2 month “grace period” provision into their Flexible Spending Account Plan, the amendment must be signed and dated before the end of the plan year.
2. The one-time Health FSA rollover into an HSA is helpful for employees where the high-deductible health plan and HSA combination is introduced for the first time.
3. Inform employees now of this new legislation so they can make any paycheck deduction changes with payroll in time for their first paycheck.
4. Participants who have their high-deductible insurance plan in place by December 1 may place the maximum IRS statutory annual limits in their HSA for that taxable year. Again, inform employees now. They really have a “second chance” to establish their HSA later in the year, but still contribute the annual maximum.
5. Direct trustee-to-trustee transfers from an individual’s IRA to their HSA should be rare. If a participant has a lot of medical expenses, and their HSA is short on funds – that would be the time to transfer money from their IRA.

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