

**Tax Relief and Health Care Act of 2006:
Legislative Changes to Health Savings Accounts**

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On December 20, 2006, the Tax Relief and Health Care Act of 2006 (the “Act”) was signed into law by the President. The Act relaxes several of the rules governing health savings accounts (“HSAs”) by making the following changes:

- Limited Distributions from Health Flexible Spending Arrangements and Health Reimbursement Arrangements to HSAs: Under current law, a distribution from a health FSA or HRA to an HSA is prohibited. For distributions on or after December 20, 2006 and before January 1, 2012, the Act allows a “qualified HSA distribution” to be directly transferred from a health FSA or HRA to an HSA. The amount of the distribution may not exceed the lesser of:
 - the balance in the health FSA or HRA as of September 21, 2006; or
 - the balance in the health FSA or HRA as of the date of distribution.

Only one distribution is allowed with respect to each health FSA or HRA of an individual. The individual must be HSA-eligible when the distribution is made and must remain eligible during the testing period, which is the period beginning with the month in which the qualified HSA distribution is made and ending on the last day of the twelfth month following such month. If an individual ceases to satisfy the HSA eligibility rules during the testing period other than by reason of death or disability, the distribution is includible in the individual’s gross income and is subject to a 10% penalty.

Further, under a modified comparability rule, an employer that allows any employee to make a distribution to an HSA from a health FSA or HRA must allow all employees covered under a high deductible health plan (“HDHP”) of the employer to make a contribution to an HSA from a health FSA or HRA. The employer is subject to a 35% excise tax if this requirement is not satisfied.

One-Time Distribution From Individual Retirement Plans to Fund HSAs: Under current law, a distribution from an individual retirement plan to an HSA is prohibited. The Act allows a “qualified HSA funding distribution” to be made from an individual retirement plan (other than a simplified employee pension or a simple retirement account) to an HSA in a direct trustee-to-trustee transfer. The amount of the distribution may not exceed the maximum deductible contribution amount to the HSA based on the type of coverage under the HDHP as of the date of distribution (i.e., self-only coverage or family coverage). The individual must be HSA-eligible when the distribution is made and must remain eligible during the testing period, which is the

period beginning with the month in which the distribution is made to an HSA and ending on the last day of the twelfth month following such month. If an individual ceases to satisfy the HSA eligibility rules during the testing period other than by reason of death or disability, the distribution is includible in the individual's gross income and subject to a 10% penalty.

Only one qualified HSA funding distribution may be made during the lifetime of an individual. However, if a qualified HSA funding distribution is made during a month in a taxable year during which the individual has self-only coverage under a HDHP as of the first day of the month, the individual may make another qualified HSA funding distribution during a subsequent month in such taxable year during which the individual has family coverage. Both contributions together may not exceed the maximum annual contribution limit to the HSA.

- Certain FSA Coverage Treated as Disregarded Coverage for HSA Purposes: Under current law, an individual participating in a health FSA that allows reimbursement during a grace period following the end of the plan year is generally not allowed to make contributions to an HSA until the month following the end of the grace period. Under the Act, coverage under a health FSA may be disregarded during the grace period if:
 - the balance of the health FSA at the end of the plan year is zero; or
 - the individual is making a qualified HSA distribution in an amount equal to the remaining balance of the health FSA as of the end of the plan year.
- Repeal of Annual Contribution Limitation on HSA Contributions: Under current law, the maximum amount that an individual may deduct under an HSA may not exceed the annual deductible under the HDHP in which he or she participates if such amount is less than the dollar contribution limit. The Act removes this limitation. Therefore, an individual is allowed to contribute an amount up to the statutory dollar limits to his or her HSA regardless of his or her HDHP deductible. Accordingly, for 2007, the maximum contribution that can be made to an HSA is \$2,850 for self-only coverage and \$5,650 for family coverage.
- Earlier Modification of Cost-of-Living Adjustments: Under current law, cost-of-living adjustments to HSA dollar limits must be made by August 31 of the preceding calendar year. For taxable years beginning after 2007, the Act requires cost-of-living adjustments for HSA dollar limits to be determined by March 1 of the preceding calendar year and published by June 1 of that year.
- Contribution Limitation Not Reduced for Part-Year Coverage: Under current law, an individual's annual HSA contribution limit is based on the number of months he or she satisfies the HSA eligibility rules during the year. The Act allows an individual who is HSA-eligible for part of the year to be considered HSA-eligible for the entire year for purposes of determining the annual HSA contribution limit. However, if the

individual fails to remain HSA-eligible during the testing period (the period beginning with the last month of the year in which the individual becomes HSA-eligible and ending on the last day of the twelfth month following such month) other than by reason of death or disability, the HSA contributions attributable to the months during which the individual was not actually HSA-eligible will be includible in gross income and subject to a 10% penalty.

- Exception to Comparability Rule for Contributions to Non-Highly Compensated Employees: Under current law, an employer contributing to the HSA of an employee must make comparable contributions to the HSAs of all comparable participating employees. A comparable participating employee is defined as an eligible employee covered under any HDHP of the employer with the same category of coverage (i.e. self-only coverage or family coverage). The Act provides an exception to the comparability rules which states that highly compensated employees (as defined in section 414(q) of the Internal Revenue Code of 1986, as amended) will not be treated as comparable participating employees for purposes of applying the comparability rules to contributions to the HSAs of non-highly compensated employees. Accordingly, the Act allows employers to make larger HSA contributions for non-highly compensated employees than for highly compensated employees.