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Employee Benefits | A Littler Mendelson Newsletter

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Just In Time For the Holidays - Changes In Health Savings Account Rules Under the New Health Opportunity Patient Empowerment Act of 2006

By Kate West Rowan and Steven J. Friedman

On December 20, 2006 President Bush signed into law H.R. 6408, the new Tax Relief and Health Care Act of 2006. Title III of this new law, which focuses on Health Saving Accounts and makes changes that can be implemented in 2007, has its own short title - the Health Opportunity Patient Empowerment Act of 2006. The HOPE Act makes Health Savings Accounts a more attractive vehicle to employers.

Brief HSA Overview

Health Savings Accounts – "HSAs" – are tax-favored spending accounts (similar to flexible spending accounts) available to those who participate in "high deductible health plans." HSA funds may reimburse the medical expenses not covered by the high deductible health plan. HSAs were created under the Medicare Prescription Drug and Modernization Act of 2003, effective for tax years beginning January 1, 2004. One very attractive characteristic of HSAs is that unused contributions continue to be available from year to year, unlike contributions to traditional flexible spending accounts that, under the "use-it-or-lose-it" rules of Internal Revenue Code Section 125, are forfeited if not used by year-end.

HSAs are available only to participants in high deductible health plans – "HDHPs" – who have no other group health coverage other than certain preventive care, dental and vision care, and certain other specialized types of insurance. The preventive care that does not count for HSA eligibility purposes is significant, including periodic health evaluations, related tests and diagnostic procedures, annual physicals, routine prenatal and well child care, immunizations, tobacco cessation programs, and obesity weight loss programs. An HDHP is a health plan under which minimum annual deductibles and maximum annual participant expense amounts fall within specified parameters: for 2006, the single coverage minimum annual deductible was $1,050 and maximum annual expense was $5,250, and the family coverage minimum annual deductible was $2,100 and maximum annual expense was $10,500. It is expected that for 2007 the single coverage minimum deductible will be $1,100 and maximum annual expense $5,300, and the family coverage minimum deductible will be $2,150 and maximum annual expense $10,750.

For 2006, participants in HDHPs can contribute to HSAs, on a tax deductible basis, a monthly amount equal to 1/12th of the annual deductible under the HDHP, up to a maximum statutory limit of $2,700 for single coverage, or 1/12th of $5,450 for family coverage. The statutory limit is subject to cost of living adjustments. For 2007 the limits are $2,850 for single coverage and $5,650 for family coverage. Employees who have attained age 55 before the end of the taxable year can contribute an additional amount, $700 for 2006 and $800 for 2007. Employers can contribute some or all of these amounts on behalf of eligible employees, so long as they do so for all of their comparable participating employees, on a tax-exempt basis (including exemption from FICA, FUTA and tax withholding). So long as the contributed amounts are used solely for eligible medical care expenses, there is no tax on the amounts used. Eligible medical care expenses are generally expenses described in Internal Revenue Code Section 213(d) (without regard to the itemized deduction limitation). As stated above, unused amounts can rollover and accumulate from year to year, with earnings, and these amounts will not be taxed if used to pay for eligible medical expenses. Any amounts used for purposes other than qualified medical expenses are subject to income tax, plus a 10% penalty tax, for those HSA participants who have not yet reached age 65. For those HSA participants who have attained age 65, HSA funds used for purposes other than qualified medical expenses will be subject to income tax, but not the 10% penalty tax.

What's New in the HOPE Act of 2006

The HOPE Act of 2006 makes the following significant changes to the HSA rules, effective January 1, 2007:

- The plan deductible limit for HSA contributions is repealed, so that the HSA contribution can be up to the statutory limit, adjusted for cost of living, even if the plan deductible amount is lower.
- So long as an individual enrolls in the HDHP effective for coverage for the last month of the calendar year, the individual can contribute and deduct the full statutory maximum to the HSA for the entire calendar year. To keep this tax deduction, the HDHP coverage must be maintained by the individual for at least a full 12 month period. Failure to do so (other than by reason of death or disability) will result in income recognition for months not covered, plus a 10% penalty tax.
- For employer contributions to HSAs, the rule requiring uniform contributions for comparable participating employees is relaxed so that employers can have flexibility in providing different HSA contribution amounts to different groups of employees, provided the structure does not favor highly compensated employees.
- HSA participants can make a one-time direct trustee-to-trustee transfer from an individual retirement account into an HSA, up to the applicable annual HSA contribution amount for the taxable year in which the transfer is made. The transfer must be irrevocable. Amounts so transferred will retain their tax-deferred status, and if used for qualified medical expenses, will be treated in the same manner as other HSA contributions. However, the HDHP coverage must be maintained for a full 12 months. Failure to do so (other than by reason of death or disability) will result in income recognition for the entire amount transferred, plus a 10% penalty tax.
- An employee who has a zero balance in a health care flexible spending account at the end of the calendar year before joining an HDHP for the next year can contribute to an HSA from the beginning of the HDHP plan coverage even though the flexible spending account has a 2½ month grace period after the end of the year for spending down unused amounts. That spend-down period won't be counted as coverage under a non-high deductible health plan under the revised HSA rule. This is important because participants in FSAs with grace periods would otherwise be excluded from HSA participation for the grace period, as the FSA would constitute group health coverage in addition to the HDHP, even though such participants would have no opportunity to benefit from the FSA due to their zero balance in the FSA during the grace period.

Observation

As premium costs increase for group health plans and employers shift a greater share of those premium costs to employees, the combination of HDHPs with lower premium costs and HSAs with their portability and year to year accumulation of unused amounts may become more attractive to both employers and employees. Changes effected by the HOPE Act of 2006 make HSAs even more attractive.

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