



SPECIAL Alert

In This Issue

In this first Special Alert for 2007, we will examine recent changes to Health Saving Accounts (HSAs) following legislation passed at the end of 2006. The new provisions will undoubtedly make HSAs a more attractive option for employers and employees.

The changes allow for increased opportunities to set aside funds on a tax-favored basis in these accounts. Hopefully, it will make the accounts a more useful tool for saving for future medical expenses.

We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

“Major Enhancements to HSAs”

Health Savings Accounts (HSAs) were implemented in 2003 when President Bush signed into law the Medicare Prescription Drug, Improvement and Modernization Act. HSAs are tax-favored trusts or custodial accounts that an individual can establish if covered by a qualifying high deductible health plan.

While HSAs sound relatively simple, they are actually quite complex. There are numerous rules for establishing and contributing to HSAs. Opponents of HSAs point to a number of these complexities when arguing that these accounts are not going to be successful in managing health plan costs long term.

Admittedly, HSAs do have features that are difficult for some participants to accept, including:

- Contributions are limited to the lesser of the plan’s deductible or the IRS set limit. For 2007, the minimum deductible is \$1,100 single or \$2,200 family. The maximum contribution for 2007 is \$2,850 single and \$5,650 family. The opposition maintains that individuals need to set aside more money than the law allows for HSAs to be an effective tool for managing care and saving for retirement health care expenses.

- In addition, all contributions are pro-rated and individuals can only contribute for the months they are covered by a qualifying high deductible health plan. This causes difficulties for employees that may only be covered for part of



the year. This is especially troublesome because it is customary to measure deductibles on a 12-month basis. If an individual is covered for only six months

of the year, the individual can only contribute half of the maximum contribution, even though it is fairly standard to have the whole deductible apply to the partial year.

- Many employers ventured into the world of Consumer Driven Health Plans (CDHPs) using Health Reimbursement Arrangements (HRAs). HRAs allow employers a bit more flexibility than HSAs. This flexibility allowed employers to ease the concept of CDHPs into their corporate philosophy. Once employees became comfortable with the CDHP approach, most had built up some savings in their HRAs. Unfortunately, HRA balances cannot roll into an HSA, and for this reason, many

employers have not launched HSAs.

HSAs are fairly complicated, which keeps some employers from launching Consumer Driven Health Plans with HSAs. However, President Bush signed into the law the Tax Relief and Health Care Act of 2006 on December 20th of last year. This Act drastically changes some aspects of HSAs and will hopefully make these accounts more attractive for employers and employees.

The Act addresses many issues that opponents of HSAs have criticized. This *Special Alert* will summarize the changes, including:

- Maximum contribution limits are no longer tied to the plan's deductible amount.
- Newly hired plan participants can contribute the entire annual maximum contribution under certain circumstances.
- Employers can make higher contributions to non-highly compensated participants' HSAs.
- The FSA "grace period" will not disqualify some individuals from contributing to an HSA.
- Transfers *under limited situations* will be permitted

from HRAs and, potentially, FSAs.

- A one-time rollover from an IRA will be permitted, subject to limitations.
- By law, the annual indexed parameters of HSAs and high deductible health plans will be announced in June of the preceding year.



This Special Alert will examine these changes in detail and the potential impact on your plan.

Contribution Limits

The IRS limits the amount of money an individual can set aside on a tax-favored basis in an HSA. The 2007 limit is the lesser of the plan deductible or \$2,850 for single coverage and \$5,650 for family coverage. Contribution limits are determined on a month by month basis. If an individual is only covered for 7 months of the year, 7/12 of the annual maximum is the permitted contribution to the account.

The new legislation amends Section 223 and no longer uses the deductible to determine the contribution maximum. As long as an individual is covered by a qualifying high deductible health plan for the entire year, the individual can contribute up to the annual maximum contributions.

This change is effective for tax years beginning on or after December 31, 2006. This is great news to individuals covered by a qualifying high deductible health plan!

A major complaint about HSAs in practice is that they do not allow for enough funds to be set aside to pay for current medical expenses, while also saving money for future medical expenses. Most plans have deductibles that are less than the current contribution maximums. This change will allow many individuals to set aside more money in their HSAs. Contributions will still be pro-rated for the number of months covered by the plan. However, in some circumstances individuals may be able to contribute the full contribution if covered only a part of the year. These circumstances are addressed in the next section.

Partial Year Participant Contributions

Another drawback to HSAs has been handling newly eligible participants on the employer's plan. Most deductibles are measured on a calendar-year basis. If an individual is hired and effective on the plan July 1st, the entire calendar-year deductible applies to the remainder of the year. Unfortunately, IRS

What is a "Qualifying High Deductible Health Plan" in 2007?

- Plan has at least a \$1,100 deductible for single coverage and a \$2,200 deductible for family coverage.
- The in-network out-of-pocket maximum can be no more than \$5,500 for single coverage, \$11,000 for family coverage in a calendar year.
- Preventive care **is the only benefit** allowed to be covered prior to satisfying the deductible.

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regulations would only allow half of the annual maximum contribution to be made to the HSA. If an individual had major medical expenses, he or she would have to meet the full plan year deductible and only be able to use the HSA for half the deductible amount.

The new regulations spell out a fairly complicated situation that would allow an individual to contribute the full annual maximum contribution even when he or she is only covered for part of the year. If an individual is newly eligible to make an HSA contribution for a partial year, and is able to make a contribution in the last month of a given tax year (this is usually measured on a calendar year basis), the individual can be deemed to have been eligible for the entire year, providing specific circumstances are met. The individual must remain eligible to make HSA contributions for the "testing period." The testing period is defined as the last month of the year and the twelve months following. This change is effective for the 2007 tax year.

This may be a difficult provision to meet and may be somewhat risky for the individual making the HSA contribution. If the individual is eligible to make contributions for the last 6 months of a tax year, at the end of the year, the individual can choose to set aside the maximum annual contribution. For this to be permitted on a tax-favored basis, the individual must remain eligible to contribute to the HSA for the entire following year, called the "testing period." If he or she does, the contributions made in the previous year remain tax-free. If



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the individual does not maintain coverage through the testing period, he or she is taxed on the amount that would not have been a permitted contribution. In this example, the employee was eligible to contribute to the HSA for half of the previous year. Therefore, if the employee is unable to contribute to the HSA during the entire testing period, half of the previous year's contribution is not permitted. Half of the previous year's contribution and any applicable interest earnings become taxable income and the individual will have to pay an excise tax of 10% on that amount as well.

The only exception to this requirement is if an individual is unable to make a contribution as a result of death or disability within the

meaning of Section 72(m)(7) of the Internal Revenue Code. If that is the case, the full annual contribution from the previous year is permitted.

This provision may be a positive one for many newly hired employees under a qualifying high deductible health plan. However, it may come at a steep price if the individual does not remain covered under a qualifying high deductible health plan for the entire following year.

Comparable Contribution Rules Amended

The IRS has issued many bulletins concerning the comparable contribution requirement for HSAs. Employers are not required to contribute to HSAs, but if they do contribute to an HSA for one employee, they must offer the same contribution to all other employees. There is some flexibility to these rules, but not a lot.

The new legislation allows employers to make comparable contributions to the HSA of any non-highly compensated employees. However, the employer can choose not to make any contribution or make a lesser contribution to the HSAs of highly compensated employees. The thought behind this provision is that employees that are considered highly compensated have the ability to set aside funds in the HSA that non-highly compensated individuals may not have. It allows employers not to be handcuffed by the comparability requirements if they want to provide their non-highly compensated individuals a greater contribution to their HSAs.

The definition of highly compensated employees is the same definition that is used in qualified retirement plans. This provision is effective for tax years beginning after December 31, 2007.

Employers have always had the ability to side-step the comparability requirements by making contributions through a Section 125 plan. However, the plan would still need to pass the non-discrimination requirements of Section 125.

One-Time HRA and FSA Rollovers

A while back, the IRS issued guidance that allowed employers to add a 2 ½ month grace period to their Section 125 plan. Unfortunately, if an employer added the grace period, it could disqualify an individual from contributing to a newly established HSA during the three months impacted by the grace period. Even if you used all the funds available in the medical FSA before year-end and could not benefit from the grace period, you would still not be able to contribute to an HSA during the grace period. The IRS considers full-scope FSAs to be "other coverage" and if an individual is covered by a high deductible health plan and other coverage, the individual can't contribute to an HSA.

The new legislation indicates if an individual is participating in an FSA with a grace period, and the only reason that person can be disqualified from making a contribution to an HSA is the FSA's grace period, then a special rule will apply. If an individual is enrolled in a full-scope medical FSA with a grace period, and becomes enrolled in a high deductible health plan as of the first of the following year, that individual can contribute to an HSA as of the first month of the high de-

ductible health plan coverage, in either of the following circumstances:

1. The balance in the medical FSA at year-end is \$0. In this example, the employee has no opportunity to benefit from the grace period, because the annual contribution to the FSA was used prior to the end of the plan year.
2. Any remaining balance in the FSA is transferred to the HSA at the end of the plan year.

Of course, if the employer changes the FSA to a limited-scope FSA for everyone during the grace period, that would be acceptable as well.

This is great news for employees and will again remove some barriers by making HSA contributions more

flexible. In addition, allowing any FSA balance to roll into an HSA helps employees avoid losing any funds in an FSA by using those funds as seed money for an HSA. It will be impor-

tant for employers to consult with their FSA administrator to determine the process for making any of these transfers. The law specifies that the employer must make the FSA (or HRA) rollover contribution to the HSA.

The rollover rule also applies to Health Reimbursement Arrangements or HRAs. Again, this is good news for employers that launched HRAs as part of their consumer driven strategy. Many employers have maintained the HRA approach because employees had accumulated funds that would need to be

used before the end of the plan year or frozen to be used by an employee upon losing the high deductible health plan coverage. That would end up being quite a headache administratively. The new provisions will allow the HRA funds to roll into the HSA at the point an individual becomes newly eligible for the HSA.

Individuals are limited to taking advantage of the FSA or HRA rollover once during their lifetime. Each account has the once per lifetime rollover limitation. The rollover provisions become effective in the 2007 tax year. This provision does include an end date. These rollover provisions will only be permitted through the year 2011. The law also includes a maximum rollover amount of the lesser of the balance in the HSA or FSA on September 21, 2006 or the balance in the account on the date of transfer. The rollover amounts are permitted over and above any annual maximum contribution allowed for the year in which the rollover is made.

In addition, to take advantage of these provisions, an individual must remain eligible to contribute to the HSA during the testing period. The testing period is the twelve months following the end of the plan year. If an employee is unable to make contributions during the entire testing period, the rollover contribution and any associated interest earnings become taxable and the 10% excise penalty applies.



One-Time Rollover from IRA

The IRS will also permit rollovers from IRAs to HSAs with certain limitations. After December 31, 2006, individuals may make a one-time, trust-to-trust transfer, from an IRA to an HSA.

The transferred amount can't exceed the contribution maximum for the year in which the transfer is made. The IRA transfer will not be included in income or subject to the early withdrawal additional tax. The IRA transfer is limited to once per lifetime.

This transfer is permitted subject to a testing period. An individual must remain qualified to contribute to an HSA for the month of the transfer and the twelve months immediately following the transfer for the transaction to remain tax-favored. If an individual fails to remain eligible to contribute to an HSA during the testing period, the amount of the IRA transfer and any associated interest earnings become taxable income and subject to a 10% excise penalty.

Annual HSA Adjustments

The new law also sets forth the timing of when the government will release the annual indexed features of high deductible health plans and HSA contributions. For the last two years, these adjustments were announced in November. Unfortunately, by November, many employers with calendar year plans have completed open enrollment. The late timing in providing the next year's indexed amounts caused difficulty for many employers.

Effective January 1, 2008, the government is legally obligated to announce the following year's inflationary increase by June 1st.

Employers welcome this advance notice as it may impact each year's benefit planning. It will also allow employers to communicate more effectively during open enrollment.



Concluding Thoughts

These changes to the HSA requirements are exciting for employers and employees alike. The new flexibility will allow employees to contribute more to an HSA, which should eliminate some of the difficult issues surrounding HSAs.

If you have any questions regarding the changes introduced by the Tax Relief and Health Care Act of 2006, please contact your McGraw Wentworth Account Director. **MW**

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