



The Act's HSA provisions are generally good news for HSA accountholders, HSA custodian/trustees, HSA administrators and employer/plan sponsors, but there are nuances of the Act that remain to be addressed. For example, will a rollover from an FSA/HRA affect ERISA applicability of the HSA? Moreover, will a decision by a participant to make a mid-year Qualified HSA Distribution from a Health FSA violate the Code Section 125 election change rules? Both Treasury and the Department of Labor may have to chip in additional guidance to shore up some loose ends.

All interested parties should quickly become familiar with the new rules. The rapidly approaching effective date will require employers, HSA custodians and administrators to quickly communicate the changes to HSA accountholders. For example, quick communications to Health FSA participants regarding the need to spend down or transfer an FSA account balance by plan year end is imperative to ensure that participants in a Health FSA with a grace period are eligible for an HSA at the beginning of the year as opposed to the first month following the end of the grace period. Also, trustees and custodians will need to act quickly to accommodate the many provisions under the Act, such as coordinating trustee-to-trustee transfers from IRAs.

The following is a more detailed overview of the Act's HSA provisions.

HSA Improvement	Pre-Act Law/ Guidance	Post Act Law	Effective Date	Commentary
Elimination of "lesser of deductible or HSA statutory limit" contribution rule.	<p>The maximum contribution was the lesser of the individual's HDHP deductible and the statutory maximum for single or family coverage (whichever was applicable).</p> <p>For example, assume Bob's deductible for single HDHP coverage in 2006 was \$1,200. The most Bob could contribute during the year was \$1,200 (as opposed to \$2,700, which was the statutory maximum for single HDHP coverage in 2006)</p>	<p>The maximum contribution amount is the statutory maximum for single or family coverage, whichever is applicable. The HSA contribution limit no longer refers to the individual's HDHP deductible amount.</p> <p>For example, assume Bob's deductible for single HDHP coverage in 2007 is \$1,200. Bob may contribute \$2,850 even though his deductible is only \$1,200.</p>	January 1, 2007.	<p>The change will allow employers and/or HSA accountholders to contribute additional amounts to the HSA to cover not only current medical expenses subject to the HDHP deductible but also other current out-of-pocket expenses above the deductible and/or future medical expenses. This will help HSA accountholders reduce current and future out-of-pocket liability.</p> <p>In addition, the new rule certainly makes post deductible HRAs and Health FSAs more valuable. Prior to the Act, if the individual had both HDHP comprehensive coverage and a post deductible HRA/Health FSA with a lower deductible, the contribution was based on the lower deductible (see Rev. Rul. 2004-45). However, under the Act, an HRA with a lower deductible will not impact the contribution requirement. This will allow employers to further reduce the burden otherwise shifted to employees in consumer driven health care plans (but not below the minimum statutory deductible).</p> <p>Last, this improvement from the Act appears to impact a number of other HSA provisions related to the deductible. For example:</p> <ul style="list-style-type: none"> <li>The limit on contributions for plans with a carry over deductible addressed in Notice 2004-50, Q-24 appears to no longer apply (although the special rule for determining the minimum deductible under such a plan for</li> </ul>

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				<p>purposes of qualification as an HDHP would seem to still apply).</p> <ul style="list-style-type: none"> <li>• Presumably, married couples who each have family HDHP coverage or where one has single HDHP coverage and the other has family HDHP coverage may now make, in the aggregate, contributions equal to the statutory maximum for family coverage without regard to coverage with a lower deductible. (see Code Section 223(b)(5); Rev. Rul. 2005-25 for summary of married couple contribution rule).</li> <li>• Employees with family HDHP coverage with embedded deductibles would appear to be able to contribute the full family statutory maximum without regard to the special rules in Notice 2004-50, Q-30 (under that guidance, the maximum contribution was the lesser of the statutory maximum for family coverage, the umbrella deductible and the individual embedded deductible multiplied by the number of family members).</li> </ul>

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<p>Increased HSA contributions for mid-year enrollees.</p>	<p>The maximum contribution for the year was the sum of the monthly limits for each month the individual was an "eligible individual" (as defined in Code Section 223) during the year. The monthly limits were 1/12 of the maximum annual contribution amount.</p> <p>For example, assume Bob enrolls in an HDHP on June 1, 2006, with a \$1,200 deductible. Assume further that Bob is an eligible individual on June 1 and throughout the remainder of the year. Although Bob's deductible from June 1 to December 31 was \$1,200, Bob could only contribute \$700 (the sum of the monthly limits for 2006).</p>	<p>An individual who first becomes an eligible individual anytime on or before the first day of December of any year is treated as though they are an eligible individual for the entire year so long as they continue to be an eligible individual (as defined in Code Section 223) during the testing period, which begins in the last month of the year that the individual became an eligible individual (without regard to when the individual became an eligible individual) and ends the last day of the 12 month period following such month.</p> <p>If the individual fails to be an eligible individual during that testing period, all contributions that could not have been made but for this rule (i.e. the contributions attributable to months preceding the month in which the eligible individual became an eligible individual) are included in gross income for the year in which the individual ceases to be an eligible individual (other than disability or death) and such amounts are subject to a 10% excise tax.</p> <p>For example, assume Bob enrolls in single HDHP coverage on June 1, 2007, with \$1,200 deductible. Bob may contribute the full annual contribution amount (determined in accordance with the Act's new contribution limit provisions). Thus, Bob may contribute \$2,850 for 2007 (even though he was only an eligible individual for seven months). Assume further that Bob terminates employment on February 1, 2008 and consequently loses coverage under the HDHP. Assume further that Bob does not elect COBRA because Bob's new employer offers free health coverage. All contribution amounts attributable to January 1, 2007, through May 30, 2007 (5/12 of \$2,850 or \$1,187.50) will be included in Bob's income and subject to a 10% excise tax.</p>	<p>January 1, 2007.</p>	<p>The Act reconciles the annual contribution limit (previously pro-rated) with the manner in which the deductible is typically applied under the HDHP (no prorating). Although good news overall, there are issues that arise with this new mid-year contribution rule. For example, any HDHP participant who terminates employment during the 12 month period must elect COBRA or elect coverage under another HDHP to avoid the adverse tax consequences under this new rule. Individuals who do not obtain HDHP coverage under a subsequent employer's plan may find this rule and the associated adverse tax consequences a bit onerous.</p> <p>This full year contribution issue also appears to apply to additional contributions applicable to eligible individuals who are or will be age 55 before the end of the year. Thus, the additional amount would not be pro-rated based upon months of eligibility.</p>

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<p>Rollover from HRA/ Health FSA</p>	<p>No amounts may be rolled over from an HRA or Health FSA to an HSA.</p>	<p>A one time, tax free rollover of the lesser of the Health FSA and/or HRA account balance in effect on September 21, 2006, or the balance as of the date of the rollover to an HSA is permitted at any time prior to January 1, 2012 ("Qualified HSA Distribution"). The Qualified HSA Distribution is treated as a rollover contribution for HSA purposes; therefore, it does not decrease the amount that may be contributed to the HSA during the year. The rollover must be made directly by the employer to the HSA custodian/trustee.</p> <p>The individual must continue to be an eligible individual (as defined in Code Section 223) for the 12 month period beginning with the month in which the Qualified HSA Distribution is made or the entire Qualified HSA Distribution will be included in gross income and subject to a 10% excise tax (except for failure to maintain eligible individual status due to death or disability).</p> <p>The Qualified HSA Distribution is subject to a modified comparability rule. If the employer makes Qualified HSA Distributions available to any employee, the employer must make Qualified HSA Distributions available to all employees covered under the employer's HDHP .</p>	<p>Limited time period beginning on date of enactment and ending January 1, 2012.</p>	<p>The rule only applies to participants who have an HRA and/or Health FSA on September 21, 2006 (thus, it would not apply for new accounts). Qualified HSA Distributions made between 2007 and January 1, 2012, could be problematic to the extent that the balance at the time of the Qualified HSA Distribution is greater than the balance on September 21, 2006. For example, assume that the Health FSA balance on September 21, 2006, is \$2,000. Assume further that the HSA balance on June 1, 2006, is \$3,000. The employer may only transfer \$2,000 (the lesser of the account balance on September 21, 2006, and the current balance). If the Health FSA is not a limited purpose Health FSA, the remaining \$1,000 Health FSA balance will disqualify the individual in accordance with Rev. Rul. 2004-45 (and subject the individual to the adverse tax consequences associated with failing to maintain eligible individual status). Thus, employers may be required to convert the Health FSA to a limited purpose FSA for all participants (see concepts set forth in our bulletin discussing Notice 2005-86) to ensure that all Health FSA participants with a Health FSA on September 21, 2006, are eligible to make Qualified HSA Distributions.</p> <p>Also, the Act fails to clarify the extent to which an employer has discretion over Qualified HSA Distributions. Must employers make Qualified HSA Distribution available until January 1, 2012 or can they limit the availability period? May employers force employees to make a Qualified HSA Distribution (e.g., where the employer wishes to establish an HSA on behalf of the employee without the employee's consent)?<sup>1</sup> Also, under what circumstances is the Qualified HSA Distribution considered "made through the cafeteria plan" and thereby exempt from the comparability rules? Additional clarifying guidance from Treasury is needed.</p> <p>Additional guidance may also be needed from the Department of Labor to clarify the extent to which Qualified HSA Distributions from a Health FSA or HRA subject to ERISA impacts the application of ERISA to the HSA under FAB 2004-1 and 2006-02. Moreover, the DOL may need to clarify the extent to which such Qualified HSA Distributions from Health FSA/HRA subject to ERISA does not violate ERISA's exclusive benefit rule.</p>

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<p>Grace Period Relief</p>	<p>In accordance with Notice 2005-86, if the individual is a participant in a Health FSA (by virtue of active participation or COBRA) on the last day of the plan year and the Health FSA has a grace period, the individual is disqualified from establishing/contributing to an HSA until the first day of the first month following the end of the grace period, without regard to whether the individual has an account balance or not.</p> <p>For example, assume Bob participates in a Health FSA in 2006 with a 2 ½ month grace period following a calendar plan year. Bob has not terminated his participation but he has a zero balance on December 31, 2006. Even though Bob is enrolled in a qualifying HDHP in 2007 and has no effective FSA coverage to speak of (due to the zero balance), Bob is disqualified from enrolling in an HSA until April 1, 2007 (the first month following the end of the grace period). The same would hold true if Bob had a balance on December 31, 2006, but exhausted that balance during the grace period.</p>	<p>An individual is not disqualified from establishing/contributing to an HSA solely because he is a participant in a Health FSA with a grace period, so long as the individual either has a zero balance on the last day of the plan year or the individual transfers the entire balance to the HSA as of the last day of the plan year.</p>	<p>January 1, 2007.</p>	<p>This is good news for employees participating in Health FSAs with grace periods whose employers did not convert the grace period to a limited purpose grace period in accordance with Notice 2005-86. However, participants whose plan year ending balance is greater than the Health FSA balance on September 21, 2006, and are thus unable to rollover the entire balance to an HSA or who do not incur expenses prior to the end of the plan year equal to the ending balance will continue to be ineligible for an HSA until the end of the grace period. Moreover, this new rule will encourage participants to incur unnecessary medical expenses prior to the end of the year to ensure that he/she is eligible for an HSA as of the first day of the next plan year.</p>
<p>Qualified HSA Funding Distribution from IRA</p>	<p>Transfers from IRAs to HSAs were not permitted.</p>	<p>A one time tax free trustee-to-trustee transfer of IRA funds to an HSA is permitted to the extent the transfer doesn't exceed the maximum annual HSA contribution amount (determined in accordance with the Act). Unlike Health FSA/HRA transfers, the IRA transfer is not treated as a rollover contribution. Thus any amounts transferred from the IRA to the HSA during the year reduce the maximum amount that may otherwise be contributed to the HSA during that year.</p>	<p>January 1, 2007.</p>	<p>HSA participants interested in such a transfer should weigh the advantages of placing IRA funds in an HSA (for future tax free distributions) against the corresponding reduction in deductible/excludable HSA contributions.</p>

HSA Improvement	Pre-Act Law/ Guidance	Post Act Law	Effective Date	Commentary
Higher contributions for non-HCEs under comparability rule	Non-HCEs and HCEs (as defined in IRC 414(q)) are not different categories of employees under the Section 4980E comparability rule and therefore must receive the comparable (same amount or same percentage of deductible) contributions.	<p>For the purpose of applying the comparability rule to contributions made to the HSAs of non-HCEs, HCEs are not considered comparable participating employees. This will allow employers to contribute more to the HSA of a non-HCE without violating the comparability rule. Most employers already avoid the comparability rule where contributions are made through a cafeteria plan.</p> <p>For example, assume employer contributes \$500 to Bob's HSA. Bob is a full-time employee of an employer with single coverage. Bob is also an HCE. The employer contributes \$700 to Rick's HSA. Rick is also a full-time employee of the employer with single coverage but Rick is a non-HCE.</p> <p>NOTE: The employer must comply with the comparability rules with respect to contributions made to HSAs of non-HCEs and with respect to contributions made to HSAs of HCEs respectively. Thus, using our example above, all full-time non-HCEs with single coverage must receive \$700 (or prorated amount in accordance with the comparability regulations) - the same as Rick-- and all full-time HCEs with single coverage must receive \$500 (or prorated amount in accordance with comparability the regulations) - the same as Bob.</p>	January 1, 2007.	<p>The comparability rules already do not apply to contributions made through a cafeteria plan (and such contribution variations favoring non-HCEs is permissible under Code Section 125 cafeteria plan non-discrimination rules) but employers who do not maintain a cafeteria plan (such as small employers) should find this rule helpful. But for the Act, employers could not contribute more to the HSAs of non-HCEs than they contribute to the HSAs of HCEs without violating the comparability rule.</p> <p>NOTE: One interpretation of the plain language of the Act would allow employers to contribute less to the HSAs of non-HCEs without violating the comparability rule, which is likely not intended. The Act indicates that HCEs are not considered comparable participating employees with respect to contributions made to the HSAs of non-HCEs. Read literally, this means that the HSA contributions for non-HCEs can be more OR LESS than the HSA contributions made to HCEs. Additional guidance may be needed.</p>
Earlier Indexed Amounts	Currently, cost of living adjustments on which many of the HSA provisions are based are not released until some time between October and November.	The Act requires Treasury to release cost of living adjustments for a year no later than June 1 of the prior year.	January 1, 2008.	This new rule will give employers more time to plan and to communicate changes to plan participants.

## Endnote

<sup>1</sup> DOL FAB 2006-02 indicated that ERISA does not apply to HSAs solely because the employer establishes an HSA on behalf of an employee and makes a contribution without the employee's consent, thereby leaving open the possibility that employers may establish HSAs on behalf of their employees.

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