SUMMARY OF HEALTH SAVINGS ACCOUNT (HSA) CHANGES IN THE TAX RELIEF AND HEALTH CARE ACT OF 2006*

ITEM	PRIOR LAW	TAX RELIEF AND HEALTH CARE ACT OF 2006	COMMENTS
INCREASED HSA CONTRIBUTION LIMITS FOR ALL INDIVIDUALS			
BOX 1	The contribution limit to a health savings account ("HSA") was the lesser of (i) 100 percent of the annual deductible (not including any deductible for out-of-network services) of the accountholder's qualifying high deductible health plan ("HDHP"), or (ii) the statutory dollar maximum (*i.e.*, for 2007, $2,850 for individual coverage or $5,650 for family coverage).	Eliminates the "lesser of" rule so that the contribution limit for anyone with HDHP coverage is the statutory dollar maximum (*i.e.*, for 2007, $2,850 for individual coverage and $5,650 for family coverage), regardless of the deductible amount under the HDHP. *Effective date: January 1, 2007*	This change increases the contribution limits and, therefore, will help reduce the risk that a person will exhaust his or her current-year HSA dollars before the out-of-pocket expense maximum is reached under the HDHP. Note: For 2007, the annual deductible in an HDHP cannot be less than $1,100 for individual coverage or $2,200 for family coverage. The annual out-of-pocket maximums for 2007 are $5,500 for individual coverage and $11,00 for family coverage.
NO CONTRIBUTION REDUCTION FOR PARTIAL-YEAR ENROLLEES			
BOX 2	Contribution limits to an HSA are based upon eligibility to make contributions (*e.g.*, HDHP coverage) in a given calendar month. Under prior law, to be eligible for the full-year's HSA contribution, a person was required to be enrolled in the HDHP in each month of the calendar year even though the HDHP deductible was not limited for partial-year coverage.	Provides for a full-year contribution to the HSA for a person who joins the HDHP after the start of the taxable year, provided that he or she continues to be eligible for HSA contributions (*e.g.*, enrolled in HDHP coverage) for a full 12 months. Failure to maintain such coverage would result in income tax and a 10-percent penalty on contributions made. *Effective date: January 1, 2007*	Individuals who enroll in HDHP coverage after the start of the year, either as part of employer-sponsored group coverage or on the individual market, remain subject to the full annual deductible under the HDHP. For such individuals, prior law limited HSA contributions to only those months in which they have qualifying HDHP coverage even though they are subject to the full year plan deductible. The Act provides an important "fix" by allowing individuals that enroll in an HDHP after the start of the taxable year to make contributions up to the full annual HSA contribution limit. There is some question as to whether eligibility for the partial-year enrollee rule requires that an individual commence HDHP coverage after the start of the taxable year, or only that the individual become HSA-eligible after the start of the year. To the extent eligibility turns only on becoming HSA-eligible after the start of the year, this would permit individuals to make full contributions to an HSA where they have other disqualifying coverage for some portion of the year (*e.g.*, because of disqualifying coverage attributable to coverage under their spouse's Flexible Spending Arrangement ("FSA") or Health Reimbursement Arrangement ("HRA")).

The Tax Relief and Health Care Act of 2006 (the "Act"), Public Law No. 109-432, was passed by the House on December 8, 2006, and the Senate on December 9, 2006. The Act was signed into law by President Bush on December 20, 2006. On February 15, 2007, the Internal Revenue Service (the "IRS") released Notice 2007-22, which provides guidance pertaining to certain of the new HSA provisions contained in the Act, notably the provisions pertaining to Qualified HSA Distributions and the "zero balance" rule with respect to FSA grace period coverage.

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CONSOLIDATION OF EXISTING HRA AND FSA FUNDS INTO HSAs			
GENERALLY *BOX 3*	An FSA or HRA for employees that provides for reimbursement of medical expenses before the employee satisfies the deductible under an HDHP disqualifies the employee from making HSA contributions even if the employee participates in an HDHP. Prior law provided no mechanism for consolidating health accounts after an employee becomes covered under an HDHP.	Provides a 5-year window for an employer to make a one-time trustee-to-trustee transfer of FSA or HRA balances to an HSA for employees on a nondiscriminatory basis ("Qualified HSA Distribution"). The amount consolidated cannot exceed the balance in the FSA or HRA as of September 21, 2006. If the employee fails to continue to be covered by the HDHP for a 12-month period after the transfer (or otherwise fails to be eligible for HSA contributions during that period), then the employee would incur income tax plus a 10-percent penalty on the transferred amounts. *Effective date: Date of enactment and sunsets December 31, 2011* IRS Notice 2007-22, which was released on February 15, 2007, provides that an employee with a balance in a general purpose health FSA with a grace period or general purpose HRA at the end of a health FSA or HRA plan year is treated as an eligible individual for HSA purposes as of the first day of the first month in the immediately following plan year if the following requirements are satisfied. Consolidated amounts that fail to meet these requirements would be included in the accountholder's income and subject to an additional 10-percent penalty: • An employer must amend the FSA or HRA written plan effective by the last day of the plan year to allow a Qualified HSA Distribution; • A Qualified HSA Distribution from the FSA or HRA must not previously have been made on behalf of an employee with respect to that particular FSA or HRA; • The employee must have qualifying HDHP coverage as of the first day of the month during which the Qualified HSA Distribution occurs, and must otherwise be an HSA-eligible individual; • The employee must elect by the last day of the plan year to have his or her employer make a Qualified HSA Distribution to his or her HSA; • The FSA or HRA must make no reimbursements	The consolidation of employer-sponsored health accounts in an HSA eliminates inequities for employees who have elected to participate in an HDHP but are precluded from making current HSA contributions because a pre-existing employer health account constitutes disqualifying "other health coverage." The requirement that the transfer not exceed the balance in the account on the statutory date limits the relief to pre-existing accounts. The one-time transfer of existing HRA or FSA funds will assist employers that seek to transition employees to HDHP coverage. The one-time transfer will help ensure that employees who are transitioning to the HDHP have HSA funds available from the start of HDHP coverage to meet initial out-of-pocket costs under the HDHP. Employees will benefit from the consolidation of the accounts because the HSA is owned by the employee and is fully portable. Under the guidance, mid-year consolidations of general purpose FSAs (including those with grace period coverage) and HRAs generally will result in taxation and penalty for accountholders. This is because, the coverage under the general purpose FSA or HRA is deemed to continue for the duration of the FSA or HRA plan year, even if amounts are "zeroed down" pursuant to a consolidation. Such coverage would be disqualifying other coverage for purposes of the eligibility rules applicable to HSAs. See Box 6 below for further discussion. The Notice also reflects the Service's view that all consolidations with respect to general purpose FSAs <u>without</u> grace period coverage generally will result in taxation and penalty for accountholders, even where the consolidation is timed for the end of the plan year. Notice 2007-22 appears to give employees certain discretion with respect to the consolidation of existing FSA or HRA amounts into an HSA. Specifically, the guidance states that the employee "must elect" by the last

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CONSOLIDATIONS – GENERALLY (CONT'D) *BOX 3 (CONT'D)*		to the employee after the last day of the plan year; • The employer must make the Qualified HSA Distribution directly to the HSA trustee by the fifteenth day of the third calendar month following the end of the immediately preceding plan year, but after the employee becomes HSA-eligible; • A Qualified HSA Distribution must not exceed the lesser of the balance in the FSA or HRA on (i) September 21, 2006, or (ii) the date of the distribution; and • Immediately after the Qualified HSA Distribution, the FSA or HRA must have a zero balance, and the employee must no longer be a participant in a non-HSA compatible health plan. Alternatively, effective on or before the date of the Qualified HSA Distribution, the FSA or HRA must be converted to an HSA-compatible FSA or HRA for all employees.	day of the plan year to have his or her employer make a Qualified HSA Distribution from the FSA or HRA to his or her HSA. Query whether a negative election would comport with the guidance (i.e., the employer will consolidate unless the individual employee opts out of the consolidation). In the case of a Qualified HSA Distribution that is made as of the close of a plan year, the requirement that the FSA or HRA be "frozen" as of the close of the plan year will preclude the use of administrative run-out periods with respect to HRAs and FSAs for the year in which a consolidation would occur. This is because the guidance expressly states that "the FSA or HRA must make no reimbursements to the employee after the last day of the plan year." Such a result seems inconsistent with existing HRA and FSA guidance that permits the use of such run-out periods and it is not clear why this requirement is necessary to effect a Qualified HSA Distribution. Employers and administrators will need to educate employees of the importance to seek reimbursements from their FSA or HRA well in advance of the close of the plan year to ensure that all covered expenses are reimbursed before funds are transferred in a Qualified HSA Distribution.
TRANSITION RELIEF FOR 2006 AMOUNTS *BOX 4*	See Box 3 for general discussion.	Notice 2007-22 provides transition relief for Qualified HSA Distributions pertaining to amounts existing as of December 31, 2006. These arrangements need not have been "frozen" as of December 31, 2006, under the general rules for Qualified HSA Distributions discussed above. Under the transition rule for 2006, distributions that have occurred under an FSA grace period during 2007 or that have occurred from an HRA during 2007, will not cause the individual to be ineligible for HSA contributions from January through March 2007, provided that the Qualified HSA Distribution from the FSA with grace period or HRA occurs no later than March 15, 2007, and consists of all amounts remaining in such FSA or HRA as of the date of the Qualified HSA Distribution (but not in excess of the September 21, 2006 balance).	In contrast to the general rule (see Box 3), the transition relief does not require that an employer have frozen an employee's FSA or HRA account balance as of the end of the 2006 plan year. Thus it appears that employers may resurrect HRA balances that may have been forfeited or otherwise terminated at year-end by employees who were seeking to be HSA-eligible as of January 1, 2007, and make Qualified HSA Distributions of such amounts into HSAs on behalf of their employees. For example, HRA balances that may have been forfeited or otherwise terminated at year-end by employees who were seeking to be HSA-eligible as of January 1, 2007. Note that an employer could not resurrect an FSA balance that forfeited on December 31, 2006, since an FSA without a grace period must forfeit any remaining funds under the "use-it-or-lose-it" rule. The transition rule requires that consolidations occur no later than March 15, 2007, which does not give

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TRANSITION RELIEF FOR 2006 AMOUNTS (CONT'D) *BOX 4(CONT'D)*			employers and administrators much time to effectuate consolidations. Although FSA amounts from 2006 must be consolidated under the transition relief or will otherwise be lost (under the "use-it-or-lose-it" rule), it appears that employers may reestablish and freeze HRAs for 2007 and then choose to consolidate reestablished HRA accounts under a Qualified HSA Distribution at a later date.
NONDISCRIMINATION RULE *BOX 5*	An employer is required under the "comparability rules" to make contributions to the HSAs of all comparable employees. Existing Treasury regulations provide extensive guidance on how to determine who are comparable employees and what is a comparable contribution. In certain circumstances, the regulations require that employers make contributions to the HSAs of employees with third-party HDHP coverage.	Pursuant to Notice 2007-22, where an employer offers one employee the option to consolidate accounts, the employer must, in accordance with the comparability rules, offer to "any otherwise eligible individuals covered by the employer's HDHP" the option to consolidate existing medical reimbursement accounts into an HSA.	It is not entirely clear whether an employee who declines a Qualified HSA Distribution may have a subsequent "bite at the apple." Notably, the statutory language of the Tax Relief and Health Care Act expressly permits an individual to make a one-time "distribution." Thus, an employee's decision not to consolidate presumably should not prevent him or her from consolidating at a later date. On its face, Notice 2007-22 does not appear to require that employers offer consolidations to employees with HDHP coverage not otherwise sponsored by the employer. In contrast, existing Treasury regulations on comparability require that employers make comparable contributions to employees including, in certain circumstances, employees with HDHP coverage sponsored not by the employer but a third party.
TAX TREATMENT GENERALLY *BOX 6*	N/A	For consolidations that satisfy either the general rule or the transition rule (see Boxes 3 and 4 above), the recipient accountholder is not taxed on transferred amounts. Additionally, such amounts do not affect or otherwise reduce the amount that an accountholder may contribute to an HSA in the year of the consolidation. This is because consolidated amounts are treated as "rollovers" and not treated as contributions for purposes of determining an individual's annual HSA contribution limit. Notice 2007-22 provides that an individual technically need not be HSA-eligible to receive a Qualified HSA Distribution. However, if an individual is not HSA-eligible immediately following a Qualified HSA Distribution, the full amount of the distribution is included in income and is subject to an additional 10 percent penalty.	Notice 2007-22 states that an individual is subject to income taxation and penalty with respect to consolidated amounts if he or he is otherwise HSA-ineligible. Regarding Circumstance 1, the guidance does not on its face permit individuals to disregard low-dollar or otherwise "de minimis" amounts remaining in an FSA or HRA immediately following consolidation. The lack of a de minimis rule could pose difficulties for the successful administration and execution of Qualified HSA Distributions. Regarding Circumstance 1; existing IRS guidance indicates that employers and administrators cannot avoid this result by immediately terminating or otherwise freezing the HRA or FSA of an employee (unless this action is taken for all employees uniformly) where amounts inadvertently remain in the HRA or FSA following a consolidation. Moreover, because each

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TAX TREATMENT GENERALLY (CONT'D) *BOX 6 (CONT'D)*		In addition to current law rules regarding when an individual is an "eligible individual," the IRS guidance indicates that an individual will be treated as HSA-ineligible and, therefore, subject to income inclusion and penalty where the following occurs: • Circumstance 1 – Where any amounts remain in a general purpose FSA or general purpose HRA immediately following consolidation. • Circumstance 2 – Where a Qualified HSA Distribution is made on behalf of an employee before he or she becomes covered by an HDHP. Under current law rules, an individual is not HSA-eligible for a given month unless enrolled in an HDHP as of the first day of the month. • Circumstance 3 – Where general purpose HRA or general purpose FSA coverage (including grace period coverage) continues after consolidation. Specifically, the IRS guidance provides that even if a Qualified HSA Distribution reduces the balance of an FSA or HRA to zero, the FSA or HRA coverage is deemed to continue for the duration of the plan year and, as such, is other disqualifying coverage.	individual is granted by statute one consolidation per FSA or HRA arrangement, remaining amounts following consolidation cannot be subsequently transferred over to the employee's HRA or FSA. Thus, employers and administrators should be careful under this new rule to ensure that all amounts in an individual's FSA or HRA are consolidated. Regarding Circumstances 2 and 3; to avoid income taxation and penalty, Qualified HSA Distributions must occur no earlier than the first day of the month in which the HSA accountholder is enrolled in an HDHP for the entire month. In a typical case where continuing FSA or HRA coverage following consolidation is treated as disqualifying coverage, employers and administrators will want to time all Qualified HSA Distributions as of the close of the plan year and make such transfers no later than 2-1/2 months following the close of the plan year.
REGARDING FSA GRACE PERIOD COVERAGE			
BOX 7	Under existing IRS administrative guidance, an employer may make FSA funds available for health reimbursements during an additional 2-1/2 month grace period following the close of the plan year. Under prior law, an employee who drew down on all funds from the FSA prior to the start of the 2-1/2 month grace period, and thus had a "zero balance" in his or her FSA during the 2-1/2 month grace period, was nonetheless treated as having disqualifying coverage that precluded HSA contributions during the 2-1/2 month period.	Provides that an employee with a "zero balance" in his or her FSA is not disqualified from HSA contributions during the 2-1/2 month FSA grace period or if the employer is otherwise making a qualifying transfer to consolidate the FSA balance in an HSA, as discussed above. *Effective date: January 1, 2007* Recent IRS guidance makes clear that for purposes of the "zero balance" rule, an individual's account balance is determined using a "cash basis" definition. Thus, pending claims, claims submitted, claims received or claims under review that have not been paid are not taken into account for purposes of determining the account balance.	This provision effectively overrides the result in Notice 2005-86. Employers that had considered eliminating the grace period because of the negative interaction with the HSA rules now may be more inclined to continue the feature. Employers and administrators had been hoping for a definition of "balance" for purposes of this new rule that took account of incurred but otherwise unreimbursed claims. It was thought that such a definition would be easier to administer and lead to greater utilization of this new rule. Notably, in addition to imposing a "cash basis" definition, the IRS guidance does not on its face provide a de minimis rule with respect to low-dollar amounts that may unintentionally remain in an FSA at end of year.

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REGARDING FSA GRACE PERIOD COVERAGE (CONT'D) *BOX 7 (CONT'D)*	Administrative guidance in the form of IRS Notice 2005-86 did not allow an employer to eliminate the 2-1/2 month grace period only for employees who elected HDHP coverage.		To take advantage of the January 1, 2007 effective date, employees who have elected HDHP coverage for January 2007 and who are participants in a calendar-year FSA that utilizes the grace period will need to have spent down the FSA by December 31, 2006, or the employer will need to make a Qualified HSA Distribution pursuant to the transition relief (see Box 4).
TRUSTEE-TO-TRUSTEE TRANSFER OF EXISTING IRA FUNDS INTO HSAS			
BOX 8	Rollovers and "trustee-to-trustee" transfers were not permitted into an HSA from a qualified retirement plan, including an individual retirement account ("IRA").	Permits a one-time tax-free irrevocable trustee-to-trustee transfer of IRA funds into an HSA. The amount of the transfer cannot exceed the applicable annual HSA contribution limit (which would vary depending on whether the person has individual or family HDHP coverage) and must be made pursuant to a direct trustee-to-trustee transfer. Failure to maintain eligibility for HSA contributions for a period of 12 months following the IRA transfer would result in income tax and a 10-percent penalty on the transfer. *Effective date: January 1, 2007*	Gives individuals access to IRA funds for HSA contributions. Because the amount of the direct trustee-to-trustee transfer cannot exceed the annual contribution limit to the HSA, the transfer of IRA funds does not increase the HSA contribution. This provision is likely to benefit individuals who opt into an HDHP and incur out-of-pocket costs during the early part of the year or before they are otherwise able to "fund up" their HSA through payroll deductions or non-transfer contributions.
EARLIER COST-OF-LIVING ADJUSTMENTS FOR HSA LIMITS			
BOX 9	HSA contribution limits and HDHP out-of-pocket limits are subject to a COLA that cannot be calculated and published by the Treasury Department until late in the year.	Amends Code section 223 to require that the Secretary of Treasury complete the indexing of the applicable limits by June 1. *Effective date: Effective for indexing in 2007 for 2008 limits*	Ensures that employers and providers have sufficient time to produce communication materials using the correct contribution amounts for programs that take effect in the next calendar year.
HIGHER CONTRIBUTION LIMITS FOR LOWER-PAID EMPLOYEES			
BOX 10	Employer contributions to an HSA (other than through a cafeteria plan) must be "comparable" for all participants. Under prior law, contributions could not differ based upon compensation or job status even where such differing contributions favored nonhighly compensated employees.	Eliminates the requirement that disallows higher contribution limits for nonhighly compensated employees. *Effective date: January 1, 2007*	Allows employers to provide higher HSA contributions – up to the statutory maximums – to nonhighly compensated employees. Because employer contributions made through a cafeteria plan are subject to more flexible rules than the general comparability rules governing HSAs, this provision is likely to be useful primarily for small businesses that do not sponsor cafeteria plans.

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