DESCRIPTION OF H.R. 6134, THE "HEALTH OPPORTUNITY PATIENT EMPOWERMENT ACT OF 2006"

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of H.R. 6134, the "Health Opportunity Patient Empowerment Act of 2006" for September 27, 2006. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 6134.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 6134, the "Health Opportunity Patient Empowerment Act of 2006"* (JCX-42-06), September 25, 2006.

DESCRIPTION OF H.R. 6134

A. Present Law

Health savings accounts

In general

Individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish a health savings account ("HSA"). In general, HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.

Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Contributions to an HSA are excludable from income and employment taxes if made by the employer. Earnings on amounts in HSAs are not taxable. Distributions from an HSA for qualified medical expenses are not includible in gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Eligible individuals

Eligible individuals for HSAs are individuals who are covered by a high deductible health plan and no other health plan that is not a high deductible health plan and which provides coverage for any benefit which is covered under the high deductible health plan. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions cannot be made to an HSA.[2] Eligible individuals do not include individuals who may be claimed as a dependent on another person's tax return.

An individual with other coverage in addition to a high deductible health plan is still eligible for an HSA if such other coverage is certain permitted insurance or permitted coverage. Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary of Treasury may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization. Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

[2] Sec. 223(b)(7), as interpreted by Notice 2004-2, 2004-2 I.R.B. 269, corrected by Announcement 2004-67, 2004-36 I.R.B. 459.

A high deductible health plan is a health plan that has a deductible for 2006 that is at least $1,050 for self-only coverage or $2,100 for family coverage and that has an out-of-pocket expense limit that is no more than $5,250 in the case of self-only coverage and $10,500 in the case of family coverage.[3] Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance, as described above. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Health flexible spending arrangement ("FSAs") and health reimbursement arrangements ("HRAs") are health plans that constitute other coverage under the HSA rules. These arrangements are discussed in more detail, below. An individual who is covered by a high deductible health plan and a health FSA or HRA generally is not eligible to make contributions to an HSA. An individual is eligible to make contributions to an HSA if the health FSA or HRA is: (1) a limited purpose health FSA or HRA; (2) a suspended HRA; (3) a post-deductible health FSA or HRA; or (4) a retirement HRA.[4]

Tax treatment of and limits on contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income (i.e., "above-the-line") of the individual. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. In the case of an employee, contributions to an HSA may be made by both the individual and the individual's employer. All contributions are aggregated for purposes of the maximum annual contribution limit. Contributions to Archer MSAs reduce the annual contribution limit for HSAs.

[3] The limits are indexed for inflation. The family coverage limits always will be twice the self-only coverage limits (as indexed for inflation). In the case of the plan using a network of providers, the plan does not fail to be a high deductible health plan (if it would otherwise meet the requirements of a high deductible health plan) solely because the out-of-pocket expense limit for services provided outside of the network exceeds the out-of-pocket expense limits. In addition, such plan's deductible for out-of-network services is not taken into account in determining the annual contribution limit (i.e., the deductible for services within the network is used for such purpose).

[4] Rev. Rul. 2004-45, 2004-22 I.R.B. 1. A limited purpose health FSA pays or reimburses benefits for permitted coverage and a limited purpose HRA pays or reimburses benefits for permitted insurance or permitted coverage. A limited purpose health FSA or HRA may also pay or reimburse preventive care benefits. A suspended HRA does not pay medical expense incurred during a suspension period except for preventive care, permitted insurance and permitted coverage. A post-deductible health FSA or HRA does not pay or reimburse any medical expenses incurred before the minimum annual deductible under the HSA rules is satisfied. A retirement HSA pays or reimburses only medical expenses incurred after retirement.

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) (for 2006) $2,700 in the case of self-only coverage and $5,450 in the case of family coverage.[5] The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. As in determining the general annual contribution limit, the increase in the annual contribution limit for individuals who have attained age 55 is also determined on a monthly basis. As previously discussed, contributions, including catch-up contributions, cannot be made once an individual is entitled to Medicare benefits.

In the case of individuals who are married to each other and either spouse has family coverage, both spouses are treated as having only the family coverage with the lowest annual deductible. The annual contribution limit (without regard to the catch-up contribution amounts) is divided equally between the spouses unless they agree on a different division (after reduction for amounts paid from any Archer MSA of the spouses).

An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. The excise tax generally is equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA.

Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

Comparable contributions

If an employer makes contributions to employees' HSAs, the employer must make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

Taxation of distributions

Distributions from an HSA for qualified medical expenses of the individual and his or her spouse or dependents generally are excludable from gross income. In general, amounts in an HSA can be used for qualified medical expenses even if the individual is not currently eligible for contributions to the HSA.

Qualified medical expenses generally are defined as under section 213(d) and include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease, including

[5] These amounts are indexed for inflation.

prescription drugs, transportation primarily for and essential to such care, and qualified long-term care expenses of the account holder and his or her spouse or dependents. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) in the case of an account beneficiary who has attained the age of Medicare eligibility, health insurance premiums for Medicare, other than premiums for Medigap policies. Such qualified health insurance premiums include, for example, Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance including employer-sponsored retiree health insurance. Whether the expenses are qualified medical expenses is determined as of the time the expenses were incurred.

For purposes of determining the itemized deduction for medical expenses, distributions from an HSA for qualified medical expenses are not treated as expenses paid for medical care under section 213. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income also are subject to an additional 10-percent tax unless made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65).

Reporting requirements

Employer contributions are required to be reported on the employee's Form W-2. Trustees of HSAs may be required to report to the Secretary of the Treasury amounts with respect to contributions, distributions, the return of excess contributions, and other matters as determined appropriate by the Secretary. In addition, the Secretary may require providers of high deductible health plans to make reports to the Secretary and to account beneficiaries as the Secretary determines appropriate.

Health flexible spending arrangements and health reimbursement arrangements

Arrangements commonly used by employers to reimburse medical expenses of their employees (and their spouses and dependents) include health flexible spending arrangements ("FSAs") and health reimbursement accounts ("HRAs"). Health FSAs typically are funded on a salary reduction basis, meaning that employees are given the option to reduce current compensation and instead have the compensation used to reimburse the employee for medical expenses. If the health FSA meets certain requirements, then the compensation that is forgone is not includible in gross income or wages and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation.[6] This requirement often is referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts remaining in a health FSA as of the end of a plan year must be forfeited by the employee. In

[6] Sec. 125(d)(2).

May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one-half months immediately following the end of the plan year during which unused amounts may be used.[7] Health FSAs are subject to certain other requirements, including rules that require that the FSA have certain characteristics similar to insurance.

HRAs operate in a manner similar to health FSAs, in that they are an employer-maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or-lose-it rule does not apply. Thus, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year.[8] Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA.

As mentioned above, subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

[7] Notice 2005-42, 2005-23 I.R.B. 1204.

[8] Guidance with respect to HRAs, including the interaction of FSAs and HRAs in the case an individual is covered under both, is provided in Notice 2002-45, 2002-2 C.B. 93.

B. Description of Proposal

1. Allow rollovers from health FSAs and HRAs into HSAs for a limited time

The proposal allows certain amounts in a health FSA or HRA to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the otherwise applicable requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006 or (2) the balance in the health FSA or HRA as of the date of the distribution. The balance in the health FSA or HRA as of any date is determined on a cash basis (i.e., expenses incurred that have not been reimbursed as of the date the determination is made are not taken into account). Amounts contributed to an HSA under the proposal are excludable from gross income and wages for employment tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. Contributions must be made directly to the HSA before January 1, 2012. The proposal is limited to one distribution with respect to each health FSA or HRA of the individual.

The proposal is designed to assist individuals in transferring from another type of health plan to a high deductible health plan. Thus, if an individual for whom a contribution is made under the proposal does not remain an eligible individual during the testing period, the amount of the contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

A modified comparability rule applies with respect to contributions under the proposal. If the employer makes available to any employee the ability to make contributions to the HSA from distributions from a health FSA or HRA under the proposal, all employees who are covered under a high deductible plan of the employer must be allowed to make such distributions and contributions. The present-law excise tax applies if this requirement is not met.

For example, suppose the balance in a health FSA as of September 21, 2006, is $2,000 and the balance in the account as January 1, 2008 is $3,000. Under the proposal, a health FSA will not be considered to violate applicable rules if, as of January 1, 2008, an amount not to exceed $2,000 is distributed from the health FSA and contributed to an HSA of the individual. The $2,000 distribution would not be includible in income, and the subsequent contribution would not be deductible and would not count against the annual maximum tax deductible contribution that can be made to the HSA. If the individual ceases to be an eligible individual as of June 1, 2008, the $2,000 contribution amount is included in gross income and subject to a 10-percent additional tax. If instead the distribution and contribution are made as of June 30, 2008, when the balance in the health FSA is $1,500, the amount of the distribution and contribution is limited to $1,500.

The present law rule that an individual is not an eligible individual if the individual has coverage under a general purpose health FSA or HRA continues to apply. Thus, for example, if the health FSA or HRA from which the contribution is made is a general purpose health FSA or HRA and the individual remains eligible under such arrangement after the distribution and contribution, the individual is not an eligible individual.

Effective date.–The proposal is effective for distributions and contributions on or after the date of enactment and before January 1, 2012.

2. Repeal of annual plan deductible limitation on HSA contribution limitation

The proposal modifies the limit on the annual deductible contributions that can be made to an HSA so that the maximum deductible contribution is not limited to the annual deductible under the high deductible health plan. Under the proposal, the maximum aggregate annual contribution that can be made to an HSA is $2,700 (as indexed for inflation after 2006) in the case of self-only coverage and $5,450 (as indexed for inflation after 2006) in the case of family coverage.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2006.

3. Earlier indexing of cost of living adjustments

Under the proposal, in the case of adjustments made for any taxable year beginning after 2008, the Consumer Price Index as of the close of the 12-month period ending on March 31 of the calendar year is used (rather than August 31 as under present law) in making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (i.e., the contribution limits and the high-deductible health plan requirements). The proposal also requires the Secretary of Treasury to publish the adjusted amounts for a year no later than June 1 of the preceding calendar year.

Effective date.–The proposal is effective for adjustments made for taxable years beginning after 2008.

4. Allow full deductible contribution for months preceding month that taxpayer is an eligible individual

In general, the proposal allows individuals who become covered under a high deductible plan in a month other than January to make the full deductible HSA contribution for the year. Under the proposal, an individual who is an eligible individual during the last month of a taxable year is treated as having been an eligible individual during every month during the taxable year for purposes of computing the amount that may be contributed to the HSA for the year. Thus, such individual is allowed to make contributions for months before the individual was enrolled in a high deductible health plan. For the months preceding the last month of the taxable year that the individual is treated as an eligible individual solely by reason of the proposal, the individual is treated as having been enrolled in the same high deductible health plan in which the individual was enrolled during the last month of the taxable year.

If an individual makes contributions under the proposal and does not remain an eligible individual during the testing period, the amount of the contributions attributable to months preceding the month in which the individual was an eligible individual which could not have been made but for the proposal are includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

For example, suppose individual "A" enrolls in high deductible plan "H" in December of 2007 and is otherwise an eligible individual in that month. A was not an eligible individual in any other month in 2007. A may make HSA contributions as if she had been enrolled in plan H for all of 2007. If A ceases to be an eligible individual (e.g., if she ceases to be covered under the high deductible health plan) in June 2008, an amount equal to the HSA deduction attributable to treating A as an eligible individual for January through November 2007 is included in income in 2008. In addition, a 10-percent additional tax applies to the amount includible.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2006.

5. Modify employer comparable contribution requirements for contributions made to nonhighly compensated employees

The proposal provides an exception to the comparable contribution requirements which allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined as under section 414(q) and include any employee who was (1) a five-percent owner at any time during the year or the preceding year; or (2) for the preceding year, (A) had compensation from the employer in excess of $100,000[9] (for 2006) and (B) if elected by the employer, was in the group consisting of the top-20 percent of employees when ranked based on compensation. Nonhighly compensated employees are employees not included in the definition of highly compensated employee under section 414(q).

The comparable contribution rules continue to apply to the contributions made to nonhighly compensated employees so that the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period.

For example, an employer is permitted to make a $1,000 contribution to the HSAs of each nonhighly compensated employee for a year without making contributions to the HSAs of highly compensated employees.

[9] This amount is indexed for inflation.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2006.

6. One-time rollovers from IRAs into HSAs

The proposal allows a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement ("IRA"). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under the proposal are not includible in income to the extent that the distribution would otherwise be includible in income. In addition, such distributions are not subject to the 10-percent additional tax on early distributions.

In determining the extent to which amounts distributed from the IRA would otherwise be includible in income, the aggregate amount distributed from the IRA is treated as includible in income to the extent of the aggregate amount which would have been includible if all amounts were distributed from all IRAs of the same type (i.e., in the case of a traditional IRA, there is no pro-rata distribution of basis). As under present law, this rule is applied separately to Roth IRAs and other IRAs.

The amount that can be distributed from the IRA and contributed to an HSA is limited to the otherwise maximum deductible contribution amount to the HSA computed on the basis of the type of coverage under the high deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the year of the contribution from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA.

Under the proposal, only one distribution and contribution may be made during the lifetime of the individual, except that if a distribution and contribution are made during a month in which an individual has self-only coverage as of the first day of the month, an additional distribution and contribution may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions.

If the individual does not remain an eligible individual during the testing period, the amount of the distribution and contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The testing period is the period beginning with the month of the contribution and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax also applies to the amount includible.

The proposal does not apply to simplified employee pensions ("SEPs") or to SIMPLE retirement accounts.

Effective date.–The proposal is effective for taxable years beginning after December 31, 2006.