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MEMORANDUM

September 16, 2005

TO: Clients

FROM: Groom Law Group

RE: IRS Proposed Comparability Regulations for Employer Contributions to HSAs

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The IRS recently issued proposed comparability regulations governing employer contributions to health savings accounts (HSAs). (Prop. Treas. Reg. § 54.4980G-1 through 5; 70 Fed. Reg. 50233 (Aug. 26, 2005)). These rules apply only to employers who make contributions to the HSAs of employees, and generally require that an employer make similar contributions for all employees who participate in the employer's qualifying high deductible health plan (HDHP). If the employer's contributions do not satisfy these rules, the employer will be subject to a 35 percent excise tax.

The IRS has previously issued guidance on the comparability rule (IRC § 4980G) in Notices 2004-2 (Q&A-32) and 2004-50 (Q&As-46 through 54). These proposed regulations significantly expand upon this earlier IRS guidance. Major changes and clarifications include the following:

- New rules and examples confirming that employers are prohibited from varying contributions for levels of coverage other than self-only and family (e.g., employee plus one), unless such contributions are equal to a percentage of the HDHP deductible;

- Clarification that it is possible to provide contributions for management employees without making contributions for non-management employees by making the employer's HDHP available only to management employees.

- New rules concerning contribution methods, including pre-funding of contributions before the beginning of the calendar year;

- New rules regarding the frequency of contributions during the year, which provide that employer contributions must be made on the same schedule for all employees, with exceptions for employees with different payrolls;

- New rules concerning contributions for former employees, which provide that contributions need not be made for former employees but if contributions are made for former employees, those contributions must be similar;

- A new rule regarding employer contributions through a cafeteria plan. Earlier IRS guidance provided that an employer could avoid the comparable contribution rules by making a contribution under the employer's cafeteria plan, but did not specify what, if any, requirements had to be satisfied for an employer to do this. The proposed regulations suggest that in order to make contributions under a cafeteria plan, an employer must offer employees a choice between the contribution and cash.

- An example on how to calculate the 35% excise tax that applies if an employer does not make comparable contributions, and a new rule that all or a portion of this excise tax may be waived if it is deemed to be excessive relative to the failure of compliance.

Observations:

These proposed regulations clarify many issues, but do not allow as much flexibility in plan design as employers will likely want. For example, under the proposed regulations, an employer cannot vary HSA contributions for employees who have different categories of family HDHP coverage (such as employee plus one versus employee plus family) without linking the contributions to a percentage of the deductible. Similarly, an employer cannot make additional contributions for employees who exhibit healthy behavior, such as completing a health risk assessment, or even make additional contributions for employees who suffer from illness or chronic conditions.

These restrictions on HSA contributions make the issue of how to make employer contributions through the cafeteria plan a significant one, because cafeteria plan contributions are an exception to these rules. However, the IRS has also adopted a restrictive rule in these proposed regulations regarding the requirements that must be satisfied for an employer to make a contribution through a cafeteria plan. That rule, if adopted in the final regulations, will likely require many employers to eliminate innovative HSA plan designs. Accordingly, the comment process is particularly important.

A detailed overview of the proposed comparability regulations follows.

I. Which Employees Are Eligible for a Comparable Contribution?

A. Employees Who Are "Eligible Individuals" for HSA Contribution Purposes

Only employees who have an HSA and participate in an HDHP and no other non-high deductible health plan (i.e., "eligible individuals" as defined in Code section 223(c) for purposes of HSA contributions) are eligible for a comparable contribution. So, an employee who has an HSA but who is no longer covered by an HDHP, or an employee who has an HSA and is covered by HDHP but is also covered by a lower deductible plan (such as a health FSA that covers all medical expenses) will not be counted in determining whether the comparability rules are met. The fact that an employee may delay in establishing an HSA during the year does not relieve the employer from meeting the comparability rules for that individual, as long as that individual establishes an HSA by December 31 of that year. If the employee does not establish an HSA by that time, the comparability rules are satisfied with regard to that employee.

Because an individual must be an "employee" to be counted in determining whether the comparability rules are met, contributions to the HSA of an independent contractor are not subject to the comparability rules. Similarly, a sole proprietor can make contributions to his or her own HSA without being subject to the comparability rules. However, if the sole proprietor makes contributions to any employee of the sole proprietorship participating in an HDHP, then the sole proprietor must make contributions to all comparable employees that are participating in the HSA. Finally, contributions by a partnership to a partner’s HSA are not subject to the comparability rules. However, as with the sole proprietor, if the partnership makes any HSA contributions to any HDHP participating employee, then the partnership must make contributions to all comparable employees. The proposed regulations detail the tax consequences of HSA contributions to partners by a partnership.

B. Employees Covered by Employer's HDHP

An employer need not make HSA contributions to the HSAs of all employees who are eligible individuals. Rather, the employer can limit its HSA contributions to the HSAs of employees that have coverage under that employer's HDHP. If the employer does not make HSA contributions to employees who have HDHP coverage outside of the employer’s plan (such as being covered under a spouse’s HDHP), then failure of the employer to make a HSA contribution on those employees’ behalf will not violate the comparability rules. However, if the employer makes HSA contributions for any employee who does not participate in an HDHP sponsored by the employer, then all such employees will have to get employer contributions to their HSAs.

C. Spouses Who Work for Same Employer

If a husband and wife work for the same employer and are both covered by the employer's HDHP due to one spouse (i.e. family coverage), the employer does not have to make HSA contributions for both employees. If each have separate coverage (i.e. each with self-only coverage), then the employer must make contributions for both employees' HSAs; however, the employer is not required to make contributions above the maximum HSA contribution limit.

II. How Are Comparable Contributions Tested?

A. Self-Only versus Family Coverage

The testing is done on contributions for employees with the same category of HDHP coverage, i.e., either family coverage or self-only coverage. This means that the employer is permitted to make different HSA contribution amounts for family and self-only coverage because all the employees with family coverage will be tested together and all employees with self-only coverage will be tested together. For example, the employer could make HSA contributions to those with family coverage under the HDHP and not for those with self-only coverage under the HDHP.

To satisfy the comparability rules, the employer must contribute for all employees with family coverage under the HDHP the same dollar amount or the same percentage of the annual deductible limit. The employer must do the same for self-only coverage. If the employer provides family coverage HDHPs with differing deductible limits, the comparability rules will be met by providing a uniform amount for all employees electing family coverage or a uniform percentage of the deductible for the various family coverage options. The same would apply to self-only coverage. The controlled group rules apply in determining which employers are aggregated for purposes of determining whether the comparability rules have to be satisfied.

B. Full-Time, Part-Time and Former Employees

In determining whether the comparability rules are met, the employee population is further broken down into subcategories: current full-time employee; current part-time employees and former employees. Former employees that are covered under the HDHP because they elected COBRA continuation coverage are not treated as former employees for testing purposes (see below for more rules regarding testing former employees). This means that different contribution amounts can be made for full-time and part-time employees, as well as former employees, without violating the comparability rules.
A full-time employee is one that is customarily employed for 30 or more hour per week; a part-time employee is customarily employed for fewer than 30 hours per week. If an employee is considered part-time for part of the year and full-time for the remainder of

the year, whether the comparability rules are satisfied is determined on a month-by-month basis.

C. No Other Testing Categories Permitted

Significantly, the proposed regulation makes clear that these are the only categories -- different HDHP coverage (family and self-only coverage) and different employment status (full-time, part-time and former employees) -- for testing whether the comparability rules are met. So, for example, if all employees have HDHP coverage through the employer, the employer may not conduct separate testing for collectively bargained and non-collective bargained employees or between collectively bargained employees. The same is true for management and non-management employees. However, if only one of these groups is covered by the employer's HDHP, only that group need receive comparable employer contributions.

D. Contributions for Employees Whose Employment Status or Coverage Category Changes During Calendar Year

For those employees that do not work for the employer for the entire year, or where their coverage status changes during the year (from self-only to family or vice versa), there are two methods of determining whether the comparability rules are met: pay-as-you go and look-back. The pay-as-you-go method looks at employer contributions made to the HSA for individuals who qualify for HSA contributions as of the first day of the month. Contributions to HSAs made at the employer’s usual payroll interval for different group of employees are deemed to be made at the same time; so that if hourly employees are paid weekly and salaried employees are paid monthly, for purposes determining comparability, they all are deemed to have contributions to their respective HSAs at the same time. Therefore, under the pay-as-you-go method the comparability rules are satisfied on a month-by-month basis – even if some employees did not remain employees for the entire year. Alternatively, the look-back method would require the employer at the end of the year to look back at all eligible employees at the beginning of each month and make an HSA contribution on behalf of employees that would ensure that the comparability rules were being met.

E. Former Employees

The proposed regulations point out special rules for testing HSA contributions for former employees. There is no requirement to make HSA contributions for former employees, even if the company contributes to the HSAs of active employees. However, if an employer makes any contributions for former employees who participate in an HDHP, the employer must make comparable contributions to all former employees.

(except for former employees who are participating in the employer-sponsored HDHP because they elected COBRA continuation coverage). These comparability rules will only apply to former employees that are participating in the HDHP sponsored by the employer. However, if the employer makes contributions for any former employee that participates in an HDHP, regardless of whether it is sponsored by the employer, then the employer must make comparable HSA contributions for all former employees regardless of whether the HDHP that they participate in is sponsored by the employer.

F. HSA/MSA Rollovers

Rollovers from another HSA or an Archer MSA are not considered to be contributions from the employer and are not subject to the comparable contribution rules. Neither will employee after-tax contribution to the HSA made via payroll deduction be subject to these rules. If an employee has both an Archer MSA and a HSA, the comparability rules apply separately to the Archer MSA and HSA. However, the employer must contribute only to either the Archer MSA or the HSA; the employer may not contribute to both.

III. When Can HSA Contributions Be Made?

Contributions can be made to an HSA at any time during the year up until April 15th. Consequently, employers can make contributions on a pay-as-you-go basis during the year, a look-back basis on or after the end of the year, or a pre-funding basis at the beginning of the year (see Section II. D. above for rules for determining comparability for employees who work part of a year or change status during the year.) The same contribution method must be used for all employees participating in the HDHP, with the exception for pre-funding contributions. The employer may make a pre-funding contribution at the beginning of the year to employees participating in the HDHP at the beginning of the year; for those hired after the beginning of the year, the employer may make contributions on pre-funding basis, a pay-as-you-go basis or a look-back basis. However, the same basis must be used for all employees hired after the beginning of the year. In addition, if an employer makes a pre-funding contribution at the beginning of the year, the fact that an individual may leave employment during the year will not adversely impact the comparability testing.

IV. What Types of Contributions Fail the Comparability Rules and How Can an Employer Make Those Contributions Under the Cafeteria Plan?

The proposed regulations make it clear that matching contributions, contributions based on an employee's participation in health assessments, disease management programs or wellness programs, or contributions based on age or service with the company, will not comply with the comparability rules. Neither will additional

contributions for those employees who are eligible for catch-up contributions (i.e., those 55 and older) meet the comparability rules. These contributions, however, could be made through a cafeteria plan.

A contribution made through a cafeteria plan will not be subject to the comparability rules. However, that contribution will be subject to the nondiscrimination rules applicable to cafeteria plans. While clearly easier to meet than the comparability rules, the cafeteria plan nondiscrimination can be problematic in many circumstances. In addition, the proposed regulations contain a new rule which suggests that in order for an employer contribution to be considered made "under a cafeteria plan," the employer would have to give the employee the option to elect to receive the contribution directly in cash. By having this cash option election, the use of a cafeteria plan for matching and other purposes may not be effective in reaching the favorable health care results that these contributions were intended to achieve.

We note also that the proposed regulation states that even though the HDHP may be provided through the employer's cafeteria plan, the employer's HSA contributions are not automatically exempt from the comparability rules and tested through the cafeteria plan nondiscrimination rules. Rather, the employer contributions to an HSA remain subject to the comparability rules unless the contribution is expressly made through the cafeteria plan, presumably by offering a cash option as described above.

V. What are the Consequences of Failing the Comparability Rules?

If the employer fails the comparability rules, then the sum of *all* the contributions that the employer made to HSAs for the year are subject to the 35 percent excise tax. There is no break out based on different coverage status or employment status. All contributions are subject to the excise tax, even if the failure was limited to one coverage status. Presumably, the employer should still be able to take a deduction for such contributions under Code section 162, however, as long as such compensation is reasonable. The regulations also state that the excise tax can be waived in situations where the excise tax imposed is excessive relative to the failure involved.

If the employer wants to correct a violation of the comparability rules, the employer cannot reduce the contributions already made to an HSA; additional contributions to an HSA must be made to employees who did not receive a comparable contribution. The additional contribution must be made by April 15 of the following year. A reasonable interest factor must be included on these correcting contributions; however, there is no requirement that the contribution be in excess of the maximum limit on HSA contributions.

VI. When Are These Regulations Effective and What Comments Has the IRS Requested?

The IRS proposes to make the comparability regulations effective for all employer contributions made on or after the date of publication as final regulations. Before adopting the proposed regulations as final regulations, however, the IRS will consider written comments that are submitted prior to **November 25, 2005**. A request for a public hearing must also be made before that date. Comments may be offered on any aspect of the proposed regulations, however, the IRS specifically requested comments on the following:

- The clarity of the proposed rules and how they can be made easier to understand;
- The application of the proposed rules to employees on FMLA leave; and
- The application of the proposed rules to employer matching HSA contributions made through a cafeteria plan, such as whether an employer's matching contributions should be limited.

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Groom Law Group has substantial experience designing and drafting defined contribution health plan arrangements, including in-depth knowledge of the HSA rules. Our DC health plan team includes Tom Fitzgerald, Bill Sweetnam, Chris Keller, Lou Mazawey, Mike Thrasher and Brigen Winters. Please contact us if you have questions in this area or if you would like our assistance in submitting comments to the IRS on these proposed regulations.