

June 8, 2007

Memorandum to Clients**IRS Issues Proposed Rules on Employer Comparable Contribution to HSAs**

On June 1st, the Internal Revenue Service issued proposed rules on the comparable contribution rules that govern employer contributions made to health savings accounts ("HSA") outside of a Code section 125 cafeteria plan. See 26 C.F.R. 54 (June 1, 2007). Final comparable contribution regulations were issued in 2006, but reserved several questions for future determination. See 71 FR 43056 (July 31, 2006). The proposed rules answer some of those questions and provide guidance for employers where employees fail to establish an HSA or notify their employers of their HSA prior to December 31st. The proposed rules also permit employers to make accelerated calendar year contributions for employees who incur qualified medical expenses exceeding current HSA contributions.

Internal Revenue Code ("Code") section 4980G requires employers who make HSA contributions to make comparable contributions to the HSA of each eligible employee. To be comparable, HSA contributions must be made to all HSA eligible employees in the same employment category with the same level of coverage in either the same dollar amount or same percentage of the health plan deductible. Employers who fail to make comparable contributions are subject to an excise tax equal to thirty-five percent of the aggregate amount of the aggregate contributions actually made. In December 2006, Congress amended Code section 4980G to allow employers to contribute greater amounts to non-highly compensated employees without violating the comparable contribution rules. The preamble to the proposed rules states that the IRS expects to issue guidance on the amendment at a later date.

Employee Fails to Notify Employer of HSA or to Establish HSA by December 31st

The proposed rules add a new requirement for employers in complying with the comparability rules when employees fail to establish an HSA prior to the end of the calendar year or to notify their employer that an HSA has been established. The previous final comparability rules required an employer to make a comparable contribution (calculating interest and months of eligibility) to an employee who opened an HSA after January 1, but reserved the question of whether contributions are required for employees who fail to establish an HSA during the calendar year. See Treas. Reg. sec. 54.4980G-4, Q\A- 6.

Under the new rules, when employees fail to establish an HSA prior to the end of the calendar year, an employer must provide these employees with a written notice by January 15th of the following calendar year notifying the employees that if they both establish an HSA and notify their employer or notify their employer of an existing HSA prior to the end of February, the employee will receive a comparable contribution to the HSA. The notice may be provided

as early as 90 days prior to the first employer contribution for that year and no later than January 15th of the following year. If required, the employer must make a contribution to the employee's HSA by April 15th. The contribution must take into account the number of months that the employee was eligible for contributions and add reasonable interest in factoring the contribution amount. The notice may be provided electronically. The proposed regulations also provide a model notice that employers may use for this purpose. If, after receiving the notice, an employee still fails to open an HSA, the employer is not required to make a contribution to the employee's HSA.

Observation

This proposed rule places new administrative burdens on employers. Under the prior rules, if an employee failed to open an HSA before the end of the calendar year, no contribution was required. Employers will now need to track employee HSAs and draft and deliver notices according to the proposed timeline, in addition to calculating interest on the delayed contributions. While the majority of employers do not have to comply with these proposed comparable contribution rules because such employers make HSA contributions through their cafeteria plans, these employers should still take note. The IRS is expected to re-propose the cafeteria plan regulations later this summer. While the cafeteria plan regulations are currently silent on the treatment of individuals who fail to open an HSA prior to the end of the calendar year, it is possible that the IRS could include a similar provision with parallel language in the nondiscrimination section of the proposed cafeteria plan regulations. Accordingly, employers who are concerned about the impact of the new requirements may want to consider responding to the IRS's request for comments.

Accelerated Employer Contributions

The proposed rules allow an employer to accelerate HSA contributions for all HSA eligible employees who have incurred qualified medical expenses that exceed the employer's current calendar year contributions. Prior guidance had limited accelerated payments only to those employees who made HSA contributions through a Code section 125 cafeteria plan. See IRS Notice 2004-50, 2004-33 I.R.B. 10, Q/A-60 (July 6, 2004).

Under the new rules, if an employer elects to accelerate contributions, such contributions must be available on an equal and uniform basis to all eligible employees throughout the calendar year. The employer is required to establish reasonable uniform methods and requirements for determining acceleration eligibility and procedures for providing accelerated contributions. Employers are not required to contribute reasonable interest on accelerated or non-accelerated HSA contributions. If an employee who received accelerated contributions terminates employment mid-year, the contributions will not violate the comparable contribution rules.

Observation

This proposed rule offers additional flexibility for employers who are interested in accommodating employee needs as they arise. Because of the additional administrative effort involved, however, we do not anticipate broad utilization of this new rule.

IRS Seeks Comments on Proposed Rules

The proposed regulations are effective for employer contributions made on or after the final regulations are published, but tax payers may rely on the proposed regulations until final regulations are issued. The IRS is inviting comments on the proposed rules until August 29, 2007 and has scheduled a public hearing on the proposed regulations for September 28, 2007.

If you have questions about the proposed regulations or are interested in filing a comment with the IRS, please contact Christine Keller, Bill Sweetnam, Brigen Winters or Heather Meade at the Groom Law Group by calling (202) 857-0620.