GROOM LAW GROUP

MEMORANDUM

August 8, 2006

TO: Clients

FROM: Groom Law Group

RE: IRS Final Comparability Regulations for Employer Contributions to HSAs

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The IRS recently issued final comparability regulations ("final regulations") governing employer contributions to health savings accounts (HSAs). Treas. Reg. § 54.4980G-1 through 5; 71 Fed. Reg. 43056 (July 31, 2006). The final regulations contain helpful clarification concerning the steps employers need to take in order to fall within the "cafeteria plan exception," allowing the employer's HSA contributions to be subject to the cafeteria plan nondiscrimination rules under Code section 125 rather than these comparability rules. In addition, the final regulations add some important flexibility, such as providing that collectively bargained employees are not subject to the rules, and expanding the categories of high deductible health plan ("HDHP") coverage for which employers may vary HSA contributions.

I. Background

Proposed comparability regulations governing employer contributions to HSAs were issued last August (Prop. Treas. Reg. § 54.4980G-1 through 5; 70 Fed. Reg. 50233 (Aug. 26, 2005)). The proposed regulations explain that if an employer makes contributions to any employee's HSA, the employer must make comparable contributions to the HSAs of all comparable participating employees. Comparable participating employees are employees who are members of the same employee category (including part-time employees, full-time employees, and former employees) and who have the same category of HDHP coverage (the proposed regulations recognize only two categories- self-only or family). If an employee is not covered by the employer's HDHP, then he or she is not a comparable participating employee and the employer is not required to make a comparable contribution with respect to that employee. However, if the employer makes a contribution to the HSA of any employee who has coverage under an HDHP not sponsored by that employer, then the employer must make comparable contributions to all eligible employees covered by any HDHP.

Comparable contributions are contributions of either the same dollar amount or the same percentage of deductible under the HDHP. The proposed regulations describe acceptable contribution methods, allowing a choice between pre-funding of contributions at the beginning of the year, "pay as you go" contributions throughout the year, or contributions made on a look-back basis. If the employer's contributions do not satisfy these rules, the employer will be subject to a 35 percent excise tax on all HSA contributions made by the employer in that calendar year.

II. Final Regulations

The final regulations generally contain the same provisions as the proposed regulations. However, the final regulations clarify and expand the proposed regulations as follows:

A. Contributions Made Through a Cafeteria Plan

In perhaps the most significant change from the proposed regulations, the final regulations clarify what requirements are necessary to "make contributions through a cafeteria plan." In the proposed regulations, it was not clear whether employees must be given the option to receive cash instead of contributions with respect to *all* employer HSA contributions in order for such contributions to be considered "made through a cafeteria plan." The final regulations make clear that an employer's contributions will be considered made through a cafeteria plan if: (1) employees are permitted to make their own contributions to an HSA by salary reduction through a cafeteria plan, and (2) all contributions are made pursuant to a written cafeteria plan document.

The significance of this clarification is that contributions made through a cafeteria plan are subject to the nondiscrimination requirements of Code section 125 rather than the comparable contribution requirements of Code section 4980G. This means that an employer is prohibited from favoring highly compensated employees or key employees with respect to cafeteria plan eligibility or benefits, including HSA contributions, but the employer is not required to contribute comparable amounts to the HSAs of employees. This should allow employers more flexibility and creativity in benefit design structures. For example, by using a cafeteria plan, employers can provide matching contributions to match employees' contributions to their HSAs. Employers can also provide various incentives, for example, by contributing to HSAs of employees who participate in health risk assessments, disease management programs or wellness programs. None of these contribution structures would pass the comparable contribution requirement under Code section 4980G without this exception.

B. Recognition of New Levels of HDHP Coverage

The proposed regulations permit different levels of contributions to be made based on an employee's category of coverage. However, the only categories of coverage recognized in the proposed regulations are self-only HDHP coverage and family HDHP coverage. This restricted employers from varying HSA contributions to correspond with common coverage categories such as employee plus one or employee plus children. The final regulations allow the category of family HDHP coverage to be subdivided into self plus one, self plus two, and self plus three or more. These categories give employers additional flexibility in their benefit designs. However, the final regulations specify that contributions with respect to the self plus two category cannot be less than contributions made under the self plus one category. Likewise, contributions with respect to the self plus three category cannot be less than those made under the self plus two category. The final regulations retain the rule from the proposed regulations that an employer who makes HSA contributions to employees with self-only HDHP coverage is not required to make any contributions to employees with family HDHP coverage, and vice versa.

C. Collectively Bargained Employees

The final regulations include a new provision regarding collectively bargained employees. If health benefits were the subject of good faith bargaining between employee representatives and the employer, then employees (and former employees) covered by such collective bargaining agreement are not subject to the comparability rules. Therefore, an employer who makes HSA contributions to any of its non-collectively bargained employees may agree to: (1) not make HSA contributions to any collectively bargained employees, (2) make HSA contributions under some collective bargaining agreements and not others, or (3) provide different levels of HSA contributions under different collective bargaining agreements.

D. Locating Former Employees

The proposed regulations specify that if an employer contributes to the HSA of a former employee without requiring that the former employee be covered under that employer's HDHP, then the employer must make comparable contributions to all former employees who are eligible employees covered under any HDHP (except those former employees who are covered under an HDHP as a result of a COBRA election). The final regulations add a provision stating that in such case, an employer must take "reasonable actions" to locate such eligible former employees. Reasonable actions include the use of certified mail, the Internal Revenue Service Letter Forwarding Program or the Social Security Administration's Letter Forwarding Service. As a practical matter, the final regulations do not provide guidance regarding how an employer would go about determining whether any former employees might be covered under a HDHP other than one sponsored by that employer. The administrative burden of locating former employees and making this determination may result in employers limiting or eliminating HSA contributions to former employees.

E. Retroactive Contributions and Reasonable Interest

Under the proposed regulations, if an employee has not established an HSA at the time the employer funds its employees' HSAs, the employer must contribute comparable amounts plus reasonable interest to the employee's HSA when the employee does establish the HSA, taking into account each month that the employee was a comparable participating employee. The proposed regulations contain an exception to this rule for employees who do not establish an HSA by December 31st, which provides that the employer is not required to make contributions for such employees for that year. The final regulations retain the rule regarding retroactive contributions, but do not adopt the December 31st exception. Instead, the final regulations contain a new reserved subsection under the heading "Employee has not established an HSA by the end of the calendar year." It is unclear why this subsection was reserved rather than drafted and included. Perhaps the IRS is considering adopting a more liberal rule (*e.g.*, if an employee does not establish an HSA within a few months of becoming an eligible individual, the employer need not make retroactive contributions for such individual).

The final regulations contain a new Q&A stating that the determination of whether interest is "reasonable" will be based on all of the facts and circumstances, but that the Federal short-term rate as determined by the Secretary in accordance with Code section 1274(d) will be

deemed reasonable. In addition to the retroactive contribution scenario described above, an employer is also required to contribute "reasonable" interest if the employer violates the comparable contribution requirements and wishes to correct by contributing additional amounts to employees' HSAs.

F. Timing of Employer Contributions

The final regulations retain and expand upon the rules in the proposed regulations concerning the timing of employer contributions for employees who do not work for the employer during the entire calendar year. Under the proposed regulations, employers could use either the pay-as-you-go or look-back method of contributions to satisfy the comparability requirements for employees who work for less than a full year. The final regulations retain this rule but clarify that for the pay-as-you go and look-back methods, an employer may establish, on a reasonable and consistent basis, periods for which contributions will be made, such as quarterly, as well as a specific date, such as the first day of the quarter. Presumably, these rules are intended to clarify that employers are not required to deviate from their scheduled funding of HSA accounts to accommodate employees who begin work after the start of the year (as long as comparable contributions for that employee are made up as part of the next scheduled funding) or terminate employment before the end of the year. The final regulations adopt the rules in the proposed regulations that address the pre-funding method without significant change.

III. Conclusion

These final regulations are effective for employer contributions to HSAs made on or after January 1, 2007. While many of the changes from the proposed regulations consist of clarifications, the regulations also impose new rules and new restrictions. For example, it is now clear that to take advantage of the cafeteria plan exception to these rules, the written cafeteria plan document must describe the ability of employees to make HSA contributions through pre-tax salary reductions. Employers who currently make or plan to make contributions to their employees' HSAs should review their health benefit arrangements and cafeteria plans in light of this new guidance as soon as possible, in order to ensure compliance by January 1, 2007.

Please contact Chris Keller or Shannon Salinas at (202) 857-0620 if you have questions regarding these regulations or if you would like assistance in implementing the new requirements described in the regulations.