



SPECIAL Alert

In This Issue

In this issue, we will review the recent guidance released by the Internal Revenue Service addressing comparable contributions to Health Savings Accounts or HSAs. HSAs are tax-favored saving accounts that are available if an individual is covered by a qualifying high deductible health plan.

Employers can offer an HSA option with a high deductible health plan. There is no requirement that an employer provide funding to the accounts. However, if the employer funds one employee's HSA, they must make comparable contributions to all employees' HSAs. This Special Alert will discuss the guidelines on what constitutes "comparable".

We welcome your comments and suggestions regarding this issue of our Special Alert. For more information on this article, please contact your Account Manager or visit the McGrawWentworth web site at www.mcgrawwentworth.com.

"Final Guidelines on Comparable Contributions With HSAs"

The IRS recently issued final guidelines for employers who decide to fund employees' Health Savings Accounts (HSAs). HSAs are individually owned trust accounts accompanied by a qualified high deductible health plan. The IRS determines the requirements of a high deductible health plan.

The IRS rules on HSAs are complex, especially regarding the comparability requirement. Employers choosing to contribute to one employee's HSA must make comparable contributions to all employees' HSAs.

The initial regulations briefly described the comparability requirements. Employers could vary contributions based on:

- Single and family coverage election
- Full- and part-time employment status
- A percentage of the deductible if more than one high deductible health plan was offered

The comparability requirements **do not** apply to contributions made through a Section 125 plan. However, the contributions made through

a Section 125 plan must meet specific non-discrimination requirements.

Because employers requested more flexibility and clarification on these requirements, the IRS issued final guidelines for the following:

- Employer comparability rules
- Excise penalties for non-comparable contributions
- Testing for comparable requirements
- Calculating comparable requirements
- Exception for Section 125 contributions

The regulations apply to employer contributions made to employee HSAs on or after January 1, 2007.

Employer Comparability Rules

The new regulations further explain comparability rules. Comparable participating employees are:

- Employees eligible to contribute to an HSA according to the IRS rules.



- Employees with the same employment status and electing the same coverage category.

The IRS guidelines clarify rules for employees in the same health plan coverage category. Initially, employers could vary contributions based solely on single- and family-coverage elections.

The new guidance expands the high deductible health plan coverage categories to allow different HSA contribution levels. The new categories include self plus one; self plus two; and self plus three or more. Contributions can now vary with each of these classes.

High deductible health plans may have an "employee plus spouse" and an "employee plus child" category. If so, the employer cannot contribute one amount to HSAs for employees with "employee plus spouse" coverage and a different amount to HSAs for employees with "employee plus child" coverage.

Under the new comparability requirements, the IRS considers "employee plus spouse" and "employee plus child" to be self plus one. In order to meet the comparability requirements, the employer must contribute the same amount for both categories because they are both essentially employee plus one.



Further, if two employees are married to each other and one covers the spouse and children under family coverage, employers must make the family contributions only for the employee electing family coverage.

The employer is **not** required to make any additional contribution to an HSA for the spouse, even though the spouse is an employee, because the spouse is already a covered dependent under the health plan.

The only exception to this situation would be if the employer made contributions to the HSAs of employees that secured high deductible health plan coverage through a spouse's employer.

Although employers may contribute to HSAs for employees covered by the organization's health plan, they are not required to contribute to the HSAs of employees covered under some other high deductible health plan. However, if the employer does contribute to an employee's HSA when the employee has high deductible health coverage elsewhere, the employer must make comparable contributions for any other employee with high deductible health plan coverage through another source. Moreover, the employer must make a good faith effort to determine what other employees may have high deduct-

ible health coverage through another source.

Employer contributions to an HSA of an independent contractor or self-employed individual are not subject to the comparability requirements. Independent contractors, self-employed individuals and sole proprietors are not considered employees under the IRS guidelines.

Partners in a partnership are also not considered employees for the purpose of comparable contribution testing. Contributions made by a partnership to a bona fide partner's HSA are treated as either a guaranteed payment under Section 707(c) of the Internal Revenue Code or treated as a distribution under Section 731 of the Internal Revenue Code. However, if the partnership contributes to the HSA of an employee not considered a partner, the partnership must make comparable contributions to the HSAs of all comparable participating employees.

Excise Penalties for Non-Comparable Contributions

Employers must make comparable contributions to comparable employees' HSAs. Employers violating these guidelines must pay a 35% penalty for all contributions made to any eligible employee's HSA during the calendar year. Depending on how much employers contribute to employees' HSAs, this could be a substantial financial penalty.

In such cases, the government may choose to waive excise penalties if the employer had a legitimate reason for failing to provide comparable contributions.

NOTABLE THOUGHTS

**SUCCESS IS A SCIENCE; IF YOU HAVE THE CONDITIONS,
YOU GET THE RESULT.**

OSCAR WILDE (1854-1900)

Continued on Page 3

Testing for Comparable Contribution Requirements

Employers must base comparable contributions on the calendar year.

The following employee categories can be tested separately for comparability purposes:

1. Current full-time employees
2. Current part-time employees
3. Former employees (this category does not include former employees continuing high deductible health plan coverage under COBRA)

The new guidance also clarifies employee classes. According to IRS rules, employees working for 30 or more hours a week are generally considered full-time. Employees working fewer than 30 hours a week are generally considered part-time.

The IRS makes an exception for employees covered by a bona fide collective bargaining agreement. Health benefits must be part of the collective bargaining agreement.

In addition, any former employees the collective bargaining agreement covers are not included in the comparability testing.

The regulations offer various examples of the new exclusion for these employees, but the end result is employers can choose not to contribute to HSAs for collectively bargained employees or can even choose to contribute different amounts for collectively bargained employees, providing the benefits are part of the union



agreement. One example even allows employers to contribute a specified number of cents per the hourly rate for the hours union employees work.

Calculating Comparable Requirements

Contributions are considered comparable if monthly contributions are either the same amount or the same percentage of the health plan deductible for eligible individuals with the same coverage category as of the first of the month. The coverage categories are single, employee plus one, employee plus two and so on. Each category is tested separately. Employer contributions to the self plus two category can be no less than the contribution to self plus one category.

Also, if an employee is covered under an FSA through a spouse's employer, the employee and the employer cannot contribute to an HSA because FSA coverage is considered other comprehensive health coverage. That employee is not counted toward the comparability requirements. The same rules apply to Medicare-enrolled employees.

The Ruling explains how to calculate comparable contributions when the employer contribution is based on a percentage of the deductible.

In one example, an employer offers two high deductible health plan options. One has a \$3,000

single deductible; the second has a \$3,500 single deductible. If the employer contributes \$1,000 to HSAs of employees covered with a \$3,000 deductible, the employer can contribute either of the following to the HSAs of employees with the \$3,500 deductible and meet the comparability requirements:

1. \$1,000 to match the contributions made for all other employees electing single coverage
or
2. \$1,167 (33.33% of the deductible rounded to the nearest whole dollar amount) - same percent as \$1,000 contribution on the \$3,000 deductible plan

As in the past, employers using any of the following approaches for contributing to employees' HSAs do **not** meet the comparability requirement:

- If an employer offers to match any employee contributions to the HSA (not under Section 125 plan).
- If the employer contributes to HSAs for only those employees who participate in a wellness or health management program.
- If the employer offers to make additional contributions for employees that have reached a certain age or have met a specific length of service requirement.

The new guidance also gives employers two permissible ways to make HSA contributions:

1. **Contributions on a Pay-as-You-Go Basis:** Employers can

contribute to HSAs on one or more than one date for all comparable employees eligible as of the first of the month. For example, employers can contribute according to payroll frequency. If the employer has different payroll frequencies for different classes of employees, contributions based on payroll frequency are considered comparable. Employers may change the amount they decide to contribute at any time, but any changes must meet the comparability requirements.

2. **Contributions on a Look-Back Basis:** Employers may determine comparable contributions at the end of the calendar year or a designated time period during the year (such as quarterly or semi-annually). In this situation, employers must consider all employees eligible during any month of the calendar year. To calculate the total annual contribution, the employer can determine the months each employee was eligible and then pro-rate the amount. If the employer offers different contributions for single and family coverage and an employee gets married on June 15, the employee would have the single pro-rated amount for the first six months of the year and the family pro-rated amount for the last six months of the year. If contributions are made on a look-back basis,



NOTABLE THOUGHTS

ONLY THOSE WHO WILL RISK GOING TOO FAR CAN POSSIBLY FIND OUT HOW FAR ONE CAN GO.

T.S. ELIOT (1888-1965)

the employer must still make contributions for any employee that terminated mid-year for any months the employee was eligible.

With both approaches, an employer must establish a reasonable and consistent time period for which contributions will be made (such as quarterly) and the actual date the money will be deposited into the account. For example, if the employer makes quarterly contributions, the employer must choose an actual date to make the deposit, such as the last day of the quarter.

Further, employers may prefund HSA contributions. If an employer decides to prefund an annual amount to an employee's HSA and the employee quits mid-year, the employer would still meet the comparability requirements. However, any contribution belongs to the employee. **The employer cannot recover the funds if the employee quits mid-year.**

If an employer chooses to prefund for all eligible participants at the beginning of the plan year, the employer must also fund the accounts for any employees that become eligible during the year. The employer can choose to fund the accounts for these employees on a

pay-as-you-go or on a look-back basis. However, the employer must use the same approach for all employees hired mid-year.

The employee must establish an HSA in order to qualify for employer contributions. The employer cannot establish the HSA for an employee. The employer pays the "comparable" contributions only after the employee actually establishes the account. Also employers must pay reasonable interest on the funds they were unable to deposit because the employee failed to establish an HSA. Employers may determine reasonable interest based on the situation. Interest calculated using the federal short-term rate is considered reasonable.

This guidance does not discuss any time limitations on the employee to establish the HSA. What if an employee waits two years to establish the HSA? Is the employer required to repay two years of comparable contributions, including reasonable interest to that employee's HSA?

While the IRS does not officially offer a time limit in this recent guidance, in the past employees had until their tax filing deadline (April 15 for most) to establish the HSA. If an employee established the HSA before the tax filing deadline, the employer had to make the comparable contributions for the prior and current year.

Continued on Page 5

Section 125 Contributions Exception

In general, the comparability requirements do not apply to HSA contributions made through a Section 125 plan. Contributions made through a Section 125 plan are, however, subject to Section 125 non-discrimination rules. To match the contributions made by employees under a Section 125 plan, employers must meet the Section 125 non-discrimination requirements.

The new guidance requires employers making contributions for employees through a Section 125 plan to allow the employee an option of "cash" or "benefits". Remember, one of the requirements of Section 125 is that it must offer the employee the option of taking cash or benefits. The following examples show how an employer can structure contributions via Section 125:

- If the cafeteria plan allows employers to contribute pre-tax money to an HSA, the employee is allowed to take the contribution in cash or benefits. The employer can offer a non-elective matching contribution or "seed money" to employees choosing to fund their HSAs with pre-tax dollars. By contributing pre-tax dollars, the employer meets the cafeteria plan requirement of "cash or benefits". In this case, the employer must indicate the contribution is non-elective. The employer must also be

able to pass the Section 125 non-discrimination tests.

- Another example addresses a situation where an employer allows employees to make pre-tax contributions to an HSA; the employee has the choice of cash or benefits. The employer offers non-elective additional contributions to employees when they complete a Health Risk Assessment or participate in the employer's wellness plan. The only employees that qualify for the additional employer contribution are



those that elect to make a pre-tax contribution to their HSA. This situation meets the cafeteria plan requirements because the employee's

pre-tax reduction meets the "cash or benefits" requirement. The employer must indicate that their contributions are non-elective and must be able to pass the Section 125 non-discrimination tests.

If an employer wishes to side-step the comparability requirements, using the Section 125 plan for the contributions is a good approach. However, the plan document must clearly outline how contributions will be handled and employees must be allowed to choose either cash or benefits.

Conclusion

The concept of comparable contributions seemed simple when HSAs were first established. Now, as employers across the country are

implementing high deductible health plans with HSA options, more and more questions are arising on how to administer comparable contributions. The new IRS guidelines answer many questions. With these answers, however, the complexity of administering comparable contributions increases dramatically.

It is no wonder that most employers who are making HSAs available for their employees with high deductible health plan coverage choose not to make any employer contribution to the HSA account.

If you have any questions regarding this new guidance, please call your McGraw Wentworth Account Director. **MW**

MCGRAW WENTWORTH TEAM

ACCOUNT DIRECTORS	PRINCIPAL PLAN ANALYST
	SR. PLAN ANALYSTS
	PLAN ANALYSTS
DIRECTOR OF TECHNICAL SERVICES	
MANAGER, CLIENT SERVICES	
ASSISTANT MANAGER, CLIENT SERVICES	
SR. ACCOUNT MANAGERS	HUMAN RESOURCE DIRECTOR
	DIRECTOR OF INFORMATION TECHNOLOGY
ACCOUNT MANAGERS	SYSTEMS SUPPORT SPECIALIST
	ADMINISTRATIVE SUPPORT
	MARKETING MANAGER
	MARKETING DEPARTMENT
CONTROLLER	

Our articles are written and produced by McGraw Wentworth staff and are intended to inform our clients and friends on general information relating to employee benefit plans. They are not intended to provide either legal or tax advice. Before implementing any welfare or pension benefit program, employers are urged to consult with their benefits advisor and/or legal counsel for advice that is appropriate to their specific circumstances.

McGraw Wentworth
 3331 West Big Beaver Road, Suite 200
 Troy, MI 48084
 Telephone: 248-822-8000 Fax: 248-822-4131
www.mcgrawwentworth.com