Employee Benefits Alert

Willis

August 2006 — Issue No. 76

Comparable Contributions to HSAs: IRS Issues Final Regulations

Health Savings Accounts ("HSAs") were introduced as part of the *Medicare Prescription Drug, Improvement, and Modernization Act of 2003* ("Medicare Reform") and quickly took hold as an important employer option within consumer directed health plans ("CDHP"). Some sources suggest that HSAs are overtaking Health Reimbursement Arrangements ("HRAs") as the vehicle of choice for the side account when introducing CDHPs to their employees.

HSAs are account-based plans that employees may use to pay for their medical expenses, and they come with very attractive tax incentives. HSAs share many characteristics of HRAs and traditional health flexible spending accounts (health FSAs), but they also feature important distinctions. (For a side-by-side comparison of HSAs, HRAs, and Health FSAs, please see *Willis EB Alert* #39.)

Key HSA tax benefits include pre-tax contributions, tax-free growth, and tax-free distributions from the HSA for qualified medical expenses. However, because the tax benefits are so attractive, HSAs are also saddled with numerous requirements and restrictions. Among other things, HSA accounts *must* be coupled with a high deductible health plan ("HDHP") that satisfies strict design requirements. In addition, other special limiting rules apply. For example, employer contributions to an HSA must be "comparable" for all comparable participating employees. Failure to make comparable contributions can result in a steep (35 percent) excise tax on the contributions — so employers do not want to violate those rules.

The IRS recently released final regulations, which can be found at the following link and are summarized below: http://www.americanbenefitscouncil.org/documents/irs_regs_comparability_073106.pdf (*Note*: The link must be copied and pasted into your browser.)

Among the differences between earlier IRS guidance and the current published release is that the final regulations provide additional subdivisions of family coverage plans that are designed to authorize greater contribution differentiation and help promote enhanced funding flexibility for employers. The new regulations also clarify the use of a cafeteria plan to deliver matching or incentive HSA contributions that might not otherwise be considered comparable, as well as clarification of who is and is not an employee for purposes of the comparability calculations.

Changes outlined in the new guidance expand options from single and family coverage to:

- Self only,
- Self plus one,
- Self plus two, and
- Self plus three or more.

Testing for single coverage programs is conducted separately from coverages with self plus one or more. Similarly "family" coverages are tested category by category. However, the employer contribution cannot be any less for the self plus two coverage option than it is for the self plus one coverage option, and the employer contribution cannot be any less for the self plus three coverage option than it is for the self plus two coverage option.

The regulations also clarify that employer contributions made through a cafeteria plan can be excluded from the comparability calculations if the plan provides that workers have the right to elect cash or other taxable benefits in lieu of all or a portion of the HSA

contribution — regardless of whether the employee actually elects to contribute any amount to the HSA by salary reduction. Of course, employer contributions made through a cafeteria plan remain subject to discrimination tests set forth under IRC Section 125.

Finally, collectively bargained employees (if health benefits were the subject of good faith bargaining and reflected in the collective bargaining agreement) do not have to be considered as employees. This generally parallels long established discrimination testing rules which exclude "union employees" from testing. In addition, contributions on behalf of independent contractors, sole proprietors and partners who are not employees can be excluded from the comparability considerations.

The regulations are effective immediately, but will apply to HSA contributions on or after January 1, 2007.

Willis' Legal & Research Group is preparing a more detailed follow-up *Willis EB Alert* that will provide additional information about the regulations. (Please note that we published *Willis EB Alert #48* back in 2005 to help explain the comparability rules under then current guidance.)

U.S. Benefit Office Locations

Anchorage, AK
(907) 562-2266

Atlanta, GA
(404) 224-5000

Austin, TX
(800) 861-9851

Baltimore, MD
(410) 527-1200

Birmingham, AL
(205) 871-3871

Boise, ID
(208) 340-0645

Boston, MA
(617) 437-6900

Cary, NC
(919) 459-3000

Charlotte, NC
(704) 376-9161

Chicago, IL
(312) 621-4700

Cincinnati, OH
(513) 762-7661

Cleveland, OH
(216) 861-9100

Columbus, OH
(614) 766-8900

Dallas, TX
(972) 385-9800

Denver, CO
(303) 218-4020

Detroit, MI
(248) 735-7580

Eugene, OR
(541) 687-2222

Farmington, CT
(860) 284-6137

Florham Park, NJ
(973) 410-1022

Ft. Worth, TX
(817) 335-2115

Grand Rapids, MI
(616) 954-7829

Greenville, SC
(864) 232-9999

Houston, TX
(713) 625-1023

Jacksonville, FL
(904) 355-4600

Knoxville, TN
(865) 588-8101

Las Vegas, NV
(702) 562-4335

Long Island, NY
(516) 941-0260

Los Angeles, CA
(213) 607-6300

Louisville, KY
(502) 499-1891

Memphis, TN
(901) 248-3100

Miami, FL
(305) 373-8460

Milwaukee, WI
(414) 271-9800

Minneapolis, MN
(763) 302-7100

Mobile, AL
(251) 433-0441

Mountain View, CA
(650) 944-7000

Naples, FL
(239) 514-2542

Nashville, TN
(615) 872-3700

New Orleans, LA
(504) 581-6151

New York, NY
(212) 344-8888

Omaha, NE
(402) 778-4851

Orlando, FL
(407) 805-3005

Philadelphia, PA
(610) 964-8700

Phoenix, AZ
(602) 787-6000

Pittsburgh, PA
(412) 586-1400

Portland, OR
(503) 224-4155

Roswell, NM
(505) 317-3397

St. Louis, MO
(314) 721-8400

San Diego, CA
(858) 678-2000

San Francisco, CA
(415) 981-0600

San Juan, PR
(787) 725-5880

Seattle, WA
(206) 386-7400

Spokane, WA
(206) 386-7400

Tampa, FL
(813) 281-2095

Washington, DC
(301) 530-5050

Wilmington, DE
(302) 477-9640