



# Health Savings Accounts: Design Guide for Employers

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*This guide is intended for use by GBS professional staff. It includes material based on informal guidance from federal regulators. Therefore, revisions to this guide may be needed at a later date based on updated formal guidance. Questions regarding specific issues and application of these rules to specific plans should be addressed to your regional help desk.*

## INTRODUCTION

This Health Savings Accounts (“HSAs”) Design Rules guide contains a summary of the major Internal Revenue Service (“IRS”) and Department of Labor (“DOL”) rules for HSAs and their underlying High Deductible Health Plans (“HDHPs”). It was created to cover typical plans, rather than all possible variations. The purpose of this guide is to present the main rules in a more user-friendly way by:

- Including examples of many rules;
- Consolidating material from multiple regulations; and
- Organizing the rules using a more design-oriented structure.

The guide does **NOT** contain all of the IRS and DOL rules. For example, the guide does not include:

- Information on how eligibility for other health plans such as VA or Tricare interacts with HSAs;
- Complete details on HSA account rules (e.g., investments rules);
- Complete rules for permitted insurance or coverage such as qualified Long Term Care premium;
- Complete rules for penalties applicable to non-qualified distributions (e.g., the definition of disability used to determine if the 20% penalty applies);
- Complete tax rules for non-employees (limited amount for partners and 2% shareholders in Appendix);
- Permitted transfers from IRAs; and
- Eligibility outside the 50 states and state/local tax rules.

**Maximum HSA Contributions:** The text below reflects 2016 maximum HSA contribution limits, 2016 maximum HSA contribution limits are \$3,350 for self-only coverage and \$6,750 for family. Please see the Appendix for complete numbers; including maximum HSA contributions, high-deductible health plan annual deductibles, and annual out-of-pocket expenses.

*The intent of this guide is to provide general information about HSA regulations. This Guide provides a summary of IRS rules applicable only to Health Savings Accounts. It does not address requirements under other federal laws such as IRS Code Section 105(h) nondiscrimination rules that apply to self-insured, high-deductible health plans (or insured plans under IRS Code Section 9815(a) once guidance is issued). Additionally, this Guide does not cover ERISA requirements which would only apply if a private employer (i.e., profit or nonprofit) takes actions that would make the HSA a group health plan (which is uncommon). It is not intended to address specific situations or provide tax advice. Questions regarding specific issues should be discussed with a tax advisor.*

## ELIGIBILITY

Health Savings Account (HSA) eligibility means an individual is permitted to:

- Set up an HSA account (new account), and/or
- Add to an HSA account (contribute).

The eligibility rules do not affect:

- Earnings on an already established HSA, or
- Ability to take distributions from the HSA.

### Four Basic Eligibility Rules

An individual must satisfy all four of the basic eligibility rules. In order to be eligible for an HSA, the individual must be:

- 1) Covered by a qualified High Deductible Health Plan (HDHP);
- 2) Not covered by any non-HDHP plan (with a few exceptions);
- 3) Not be entitled to Medicare; and
- 4) Not eligible to be claimed as a dependent on another individual's tax return.

The eligibility rule works on a monthly basis. If an individual satisfies all four rules on the first day of the month, he is eligible for the entire month. If he first satisfies the four rules on the 2<sup>nd</sup> day of the month, he becomes eligible on the 1<sup>st</sup> day of the following month.

#### ***#1 – Qualified High Deductible Health Plan (HDHP)***

Only individuals covered under a qualified High Deductible Health Plan (HDHP) are HSA eligible. An individual without health coverage, for example, is not permitted to establish or contribute to an HSA. HDHP plans must also provide “significant” benefits in order to be qualified HDHPs. If a plan only provides benefits for the expenses of hospitalization or in-patient care, would not be a qualified HDHP.

In order to qualify, the HDHP must have:

- 1) Annual deductibles at or above the statutory minimums; and
- 2) Out-of-pocket limits at or below the statutory maximums.

Statutory minimums and maximums are indexed each year (see Appendix for specific dollar amounts). The minimum deductibles and maximum out-of-pocket values also apply to plans with a short plan year – they are not prorated. For example:

ABC organization has a calendar year medical plan. ABC decides to add an HDHP and HSA on July 1 (6 months for the new plan). The minimum statutory HDHP deductible for single coverage for that year is \$1,300. The minimum deductible for the first plan year (7/1-12/31) must be \$1,300. ABC cannot use \$650 (1/2 of \$1,300).

There are two levels of deductibles and out-of-pockets limits:

- 1) Self-only (i.e., only one individual covered); and
- 2) Family (i.e., more than one individual covered).

Deductible and out-of-pocket levels are indexed on an annual basis. The IRS provides these values by June 1 of the preceding year. Non-calendar year plans may use the deductibles and out-of-pocket limits in effect on the first day of their Plan Year.

### Rules Applicable To Deductibles

Three rules apply to single and family deductibles:

- 1) The deductible is an annual amount – based on 12 months. Plans with a carry-over feature must make an adjustment to meet the minimum level. For example, if a plan has a 3 month carry-over provision and the statutory minimum is \$1,300, the minimum deductibles the HDHP plan must have are:

Single  $\$1,300 \times 15/12 = \$1,625$

Family  $\$2,600 \times 15/12 = \$3,250$

Note: Some plans may prefer to eliminate the deductible carry-over from their HDHP.

- 2) Managed care plans must have in-network deductibles at or above the minimum level. For example, if the statutory minimum deductibles are \$1,300 single and \$2,600 family, a PPO plan may have the following deductibles.

COVERAGE LEVEL	IN-NETWORK	OUT-OF-NETWORK
Single	\$1,300	\$2,500
Family	\$2,600	\$5,000

A plan that uses \$1,300 single and \$2,600 family for out-of-network benefits with lower deductibles in-network is not a qualified HDHP.

- 3) The plan may not reimburse expenses before the deductible is satisfied. The only exception is for preventive care.

Note: The expenses incurred toward a family deductible may be credited toward satisfaction of a single deductible if an individual changes from family to single HDHP coverage during the year. The employer must comply with COBRA rules for allocating deductibles. Regulations provide several examples of acceptable methods for allocating the deductible.

## Out-of-Pocket Rules

Four rules apply to single and family out-of-pocket limitations:

- The out-of-pocket is an annual amount.
- The out-of-pocket amount includes the deductible and any coinsurance or copayments. It does not include contributions toward the cost of coverage.
- The out-of-pocket maximums apply to in-network benefit levels for managed care plans. Maximums may be higher for out-of-network benefits: For example, if statutory maximum out-of-pocket limits for a particular year are \$6,550 single and \$13,100 family, a PPO plan could use the following out-of-pocket maximums.

Coverage Level	In-Network	Out-of-Network
Single	\$6,550	\$10,000
Family	\$13,100	\$15,000

- Certain expenses may be disregarded when calculating the out-of-pocket maximum under the plan:
  - Cost containment penalties (e.g., \$500 for failure to pre-certify a hospital stay).
  - Plan exclusions such as experimental treatments (other than approved clinical trials, for participants in non-grandfathered health plans), or charges above reasonable and customary levels, or services that are not medically necessary.
  - Amounts over reasonable plan maximums, such as charges for chiropractic treatments over the plan's maximum (e.g., 40 treatments per year).

Note: The Patient Protection and Affordable Care Act ("PPACA") has limited the out-of-pocket maximum that may be used by employers sponsoring non-grandfathered medical plans. For 2014, the limit was equal to the out-of-pocket maximum for HSAs. However, beginning in 2015, the maximum out-of-pocket limits for non-grandfathered medical plans and high deductible health plans began to diverge. That divergence will continue in 2016 when the out-of-pocket maximums for high deductible health plans will be \$6,550 for self-only coverage and \$13,100 for other than self-only coverage. The out-of-pocket maximums that may be used under a non-grandfathered health plan in 2016 will be \$6,850 for self-only coverage and \$13,700 for other than self-only coverage.

In addition, an FAQ issued on May 26, 2015 adds an "embedded" out-of-pocket maximum that will apply to non-grandfathered medical plans beginning in 2016. Under this new rule, other than self-only coverage under a non-grandfathered medical plan may not have an out-of-pocket limit greater than \$6,850 for any individual. Under IRS rules for an HSA, the HDHP could be structured so that cost-sharing continues until the family as a unit has reached the \$13,100 limit – even if the entire \$13,100 is attributable to only one family member. Under the FAQ rule for non-grandfathered medical plans, the HDHP must limit cost-sharing for each individual in the family to \$6,850 in addition to the \$13,100 limit on the family as a unit.

### ***# 2 – Not Covered by any Non-HDHP***

In order to be eligible, the individual must **not** be covered under any non-qualified health care plan (non-HDHP plan), with two exceptions, permitted insurance and permitted coverage (see chart on the next page). Individuals covered under these plans are eligible to contribute to an HSA as long as they satisfy the other eligibility rules. The IRS has clarified that coverage under a typical EAP, wellness or disease management program (generally very limited scope medical coverage) does not make an individual HSA ineligible. Additionally, the IRS has stated that



effective for months following December 31, 2015, otherwise eligible veterans receiving hospital care or medical services under any law administered by the Secretary of Veterans Affairs for a service-connected disability are not ineligible to contribute to an HSA on a pre-tax basis.

Permitted insurance and permitted coverage are:

Insurance	Coverage
Workers' compensation	Accident coverage
Tort liability ( <i>e.g., general liability insurance</i> )*	Disability
Ownership liability ( <i>e.g., auto insurance</i> )	Dental
Specified disease coverage ( <i>e.g., cancer policy</i> )*	Vision
Per diem indemnity insurance ( <i>e.g., \$200 per day during hospital confinement regardless of actual expenses</i> )*	Long term care

\*Must be insured.

Some state insurance laws require medical plans to cover specific services with no deductible. If the services that must be covered with no deductible do not fit the HSA exceptions – preventive care or permitted insurance or coverage in the chart above – the plan is not a qualified HDHP. Employees enrolled in a non-HDHP medical plan are not HSA eligible.

Note: Preventive care is based on the IRS definition, not state law.

In May 2014, HHS issued guidance that expanded the type of payments that a “fixed indemnity insurance contract” could make and still be an “excepted benefit” for purposes of HIPAA and PPACA. Under that guidance a fixed indemnity plan could also provide some benefits on a per service basis (e.g., \$30 for an office visit) and still be an excepted benefit. However, that guidance does not change what is permitted insurance for HSAs. A fixed indemnity insurance policy that only reimburses on a per diem (or other time frame) basis is permitted insurance. A fixed indemnity insurance policy that includes any per service reimbursement is not permitted insurance and makes an individual HSA ineligible.

## Non-HDHP Plans – Common Examples

Non-qualified health plans (non-HDHP plans) include coverage under a variety of types of plans from different sources. Some common plans that cause an individual to lose eligibility for an HSA are below.

**Coverage under a spouse's health plan** unless that plan is also a qualified HDHP. An employee whose spouse has family health coverage would be ineligible to set up an HSA. If, however, his spouse has single or parent and child coverage (the employee is excluded), the employee is eligible to set up an HSA for himself as long as he is covered under an HDHP.

**Coverage under a health FSA (plan with no grace period)** – either the individual's or another family member's (usually the spouse). Most FSAs are non-HDHP health plans and cause the individual to lose HSA eligibility. FSAs that do not cause the loss of HSA eligibility are HSA compatible. These are FSAs which:



- Do not reimburse any expenses until the HDHP statutory deductible\* (e.g., \$1,300 single) has been satisfied; or
- Are limited to reimbursing permitted coverage such as dental, vision and preventive care expenses; or
- Exclude the individual who wants to establish an HSA. (Most FSA plans are not currently designed this way.) Some employers may be considering FSA plan designs that exclude specific individuals. One example is a single FSA – a plan that only covers the employee. If an employee selected a single coverage FSA, the spouse would not be prevented from establishing an HSA (the employee would be prevented).

\*Only expenses covered by the HDHP may be used to determine if the HDHP statutory deductible has been satisfied.

**Coverage under an FSA (plan with grace period)** – Individuals enrolled in these FSAs will not be eligible for an HSA during the grace period unless:

- The individual had a \$0 balance on a cash basis on the last day of the plan year; or
- The health care FSA automatically converts to a limited purpose or post-deductible FSA (HSA compatible FSA) during the grace period for all participants.

**Coverage under an FSA with a Carryover.** Enrollment in a general purpose FSA with a carryover provision makes an individual ineligible to contribute to an HSA for the entire plan year. This includes an individual who has coverage under the general purpose health FSA only as the result of a carryover of an unused amount from the prior year. Under IRS guidance released in March 2014, there are three ways that an employer may structure their plan so that employees enrolled in a general purpose FSA with a carryover provision can preserve HSA eligibility for the following plan year:

- Permit employees enrolled in the general purpose health FSA to decline or waive the carryover of amounts to the next plan year. This waiver must be made before the next plan year begins.
- If the cafeteria plan offers both a general purpose and an HSA-compatible FSA, permit employees to enroll in an HSA-compatible FSA for the following year (employee must be HSA eligible) and carry over unused balances to the HSA-compatible FSA for following plan year. This election must be made before the plan year begins for the HSA-compatible FSA.
- If the cafeteria plan offers both a general purpose and an HSA-compatible FSA, when the employee enrolls in an HDHP for the following year automatically treat the employee as enrolled in the HSA-compatible FSA for the following year and transfer unused funds (up to the \$500 limit) to the HSA-compatible FSA.

**Coverage Under An HRA** – either the individual's or another family member's (usually the spouse). Some exceptions are HRAs which:

- Reimburse only permitted coverage or premiums for permitted insurance (Note: HRAs may not reimburse premiums for individual health insurance that is not an excepted benefit);
- Do not pay benefits until the applicable (statutory level) deductible\* has been satisfied;
- Do not pay benefits until retirement (Retirement HRA -- HSA eligibility ends when the individual retires and is eligible to receive benefits from the HRA);
- Do not pay benefits during the Plan Year in which the individual contributes to an HSA (suspended HRA); or

- Exclude specific individuals such as a spouse by design (i.e. the individual is not eligible under the plan). Few HRA plans are currently structured to cover or exclude specific individuals.

\*Only expenses covered by the HDHP may be used to determine if the HDHP statutory deductible has been satisfied.

**Coverage under limited benefit plans.** HDHPs must provide comprehensive medical benefits in order to be qualified. A plan that provides coverage for only a narrow range of medical care will not be a qualified HDHP. For example, a plan that only covers inpatient hospital treatment would not qualify. Because this plan covers only limited services, the individual would be responsible for a significant amount of medical – outpatient expenses such as doctor’s office visits, outpatient x-ray & lab charges, outpatient therapy, durable medical equipment, emergency room treatment, prescription drugs etc. Under an inpatient expenses only plan the individual’s potential out-of-pocket cost would be significantly greater than the maximum statutory level.

**Coverage under an employer plan that reimburses expenses below the minimum deductible.** Some employers purchase a high deductible medical plan from an insurance company and also create a self-funded benefit that reimburses for expenses before that deductible is satisfied. If the employer pays expenses (except for preventive care) before the statutory minimum deductible is satisfied, the plan will not qualify as an HDHP.

**Telemedicine and HSAs.** To be able to contribute to an HSA, an individual must have coverage under a high deductible health plan (“HDHP”) and must not have any other disqualifying coverage. Telemedicine services can constitute disqualifying coverage if they provide coverage for services before the employee’s annual statutory minimum deductible has been met. If an employee has disqualifying coverage, then the employee is not eligible to make contributions to an HSA (and the employer is not eligible to make contributions to an HSA on his or her behalf).

It is possible that particular telemedicine programs may not be disqualifying coverage. For example, if the telemedicine services are limited to preventive services, or if they qualify as “permitted insurance” or “permitted coverage,” then the services would not be disqualifying coverage. Note that these exceptions are somewhat narrow, and in general many telemedicine programs provide a more robust array of group health plan services and would not meet these exceptions.

One way to address these concerns would be to coordinate the telemedicine program with the existing HDHP. For example, individuals could still contribute to an HSA and receive services through a telemedicine program as long as they were required to pay the entire cost of the telemedicine services themselves before the annual statutory deductible is met. Then, after they met their annual statutory deductible, participants could begin to receive employer paid telemedicine services.

### **Potential Problem Designs**

The following plan designs are not qualified HDHPs. Individuals covered under any of these plans would not be HSA eligible.

### **Deductible Pitfalls**

The examples that follow assume that the deductibles are \$1,300 single and \$2,600 family (2016 statutory minimums). Statutory deductibles vary by year (see Appendix for specific dollar amounts).

Deductible too low or not indexed: Statutory minimum is \$1,300 (2016). Plan has a \$1,300 single deductible with a 3-month deductible carry-over provision. The minimum deductible with a 3 month carry-over provision would be \$11,625 ( $\$1,300 \times 15/12 = \$1,625$ ).

Payments before statutory deductible satisfied: For example, flat dollar copays (\$10 drug/\$20 office visit/\$50 emergency room) or an employer self-funded plan which reimburses expenses below the minimum statutory deductible.

Embedded Deductibles: \$1,300 per person/\$2,600 maximum family deductible where the plan reimburses expenses when the family as a unit satisfies the family deductible or when any individual satisfies the per person deductible.

Note: Embedded deductibles using \$2,600 per person and \$5,000 per family would satisfy the rules since no individual would be reimbursed before the \$2,600 family deductible for a qualified HDHP has been satisfied.

Coverage under an employer plan that reimburses expenses below the minimum statutory deductibles: ABC buys a \$2,600 (single) deductible plan from an insurance company. In addition, ABC creates the following self-funded medical plan:

Covered Expense	Employee Pays	Employer Pays
First \$600	<b>\$600</b>	<b>\$0</b>
Next \$2,000	<b>\$400</b>	<b>\$1,600*</b>
Insurance company pays after \$2,500		

\*80% of expenses over \$600 deductible

Because the employer reimburses expenses below the statutory deductible, the employee is covered by a plan that is not an HDHP and is not HSA eligible. If the employer purchased a \$4,500 (single) deductible plan from the insurance company, the employee (single) paid the first \$1,500 with the employer paying the next \$3,000, the employer's self-funded plan + the insurance policy would qualify as a HDHP.

Note: This type of arrangement could affect the insurance company's rates and/or not satisfy the carrier's underwriting requirements.

### ***Out-of-Pocket Pitfalls***

The examples that follow assume that the out-of-pocket limits are \$6,550 single and \$13,100 family (2016 statutory maximums). Statutory out-of-pocket maximums vary by year (see Appendix for specific dollar amounts). Examples of out-of-pocket limits that are too high are:

- \$6,800 single out-of-pocket maximum for in-network services
- \$6,000 single out-of-pocket maximum for in-network, but does not include the \$1,250 deductible (total out-of-pocket  $\$6,000 + \$1,250 = \$7,250$ )

- \$15,000 family out-of-pocket

### Limited Benefit Plans

HDHP plans must also provide comprehensive (called “significant” in the regulations) benefits in order to be qualified HDHPs. If a plan only provides benefits for the expenses of hospitalization or in-patient care, significant other benefits (i.e., outpatient care benefits) are not covered under the plan. Any benefits not paid under the plan (i.e., outpatient care in this example) would be treated as an out-of-pocket expense. The result is that the out-of-pocket maximum under this plan design would be significantly greater than the amount permitted (e.g., \$6,550 for single). Regulations include two examples of limited benefit plans which are not qualified HDHPs.

One of the two examples in the regulations is a plan that reimburses inpatient hospital expenses, same day surgery facility charges and a few other services. The design described in the regulations provides the following coverage:

- \$2,000 self-only deductible
- \$6,050 out-of-pocket maximum
- Covered services:
  - Hospital inpatient care (room, services & supplies, pathology, anesthesia, surgery, and attending physician)
  - Same day surgery facility care (does not include ER, trauma center or doctor’s office)
  - Organ transplant benefit (no details included)
  - Hospice care benefit (no details included)
  - Home health care visits (max 60 after hospitalization)
  - Ambulance services
  - Preventive care screenings

The plan does not pay for:

- Doctor’s office visits
- Prescription drugs
- Any other out-patient care

This plan fails to qualify as an HDHP because with the limitation of coverage to inpatient hospital and same day surgery, significant other benefits do not remain. The underlying problem is that the individual’s out-of-pocket will be substantially greater than the statutory maximum because of the limitations on the services covered. While not stated in the regulation, other types of care that would not be covered by the plan would include: doctor’s office visits, outpatient diagnostic and lab work, physical therapy, durable medical equipment, home health care not preceded by hospitalization, chemotherapy, outpatient surgery in a different setting such as a doctor’s office, hospital emergency room care, and outpatient prescription drugs.

### ***#3 – Not Entitled to Medicare***

Individuals who are entitled to Medicare are not eligible to establish or contribute to an HSA. Entitled means **actually covered** under any part of Medicare – Part A, Part B, a Medicare Advantage plan (Part C) or Part D. Individuals who are eligible for Medicare, but are not enrolled, may establish and contribute to an HSA account.

Most active employees age 65 and older are eligible for Medicare. Some will enroll in Part A because it is free, but not other parts such as Part B or Part D that require a monthly premium payment. These individuals are not HSA eligible.

Note: Individuals who are not enrolled in either Part A or Part B of Medicare are not eligible for Medicare Part D.

#### ***#4 – Not a Tax Dependent of Another Person***

Any individual who is eligible to be claimed as a dependent on another person's federal tax return is not eligible to establish or contribute to an HSA. This is true even if the other person does not claim the individual as a dependent.

Note: A spouse is not a dependent under the Internal Revenue Code.

One example is a 24-year-old graduate student who has an individual health policy that qualifies as an HDHP, but her parents are **entitled** to claim her as a dependent because she satisfies the requirements for a “qualifying relative” under Internal Revenue Code Section 152. Even if her parents choose not to claim her as a dependent on their tax return, she is still **not** HSA eligible.

## HSA ACCOUNT & CONTRIBUTIONS

All HSAs share a number of common characteristics and are subject to the limits on annual contributions. Basic characteristics of HSA accounts and the rules for determining maximum allowable annual contributions to the account are outlined in the pages that follow.

### Basic HSA Account Characteristics

All HSAs have four basic characteristics:

- 1) A trust or custodial account is established by a bank, insurance company or other entity approved by the IRS as an HSA trustee.

Note: An employer may select an HSA trustee as long as there are no restrictions on the employee's taking the money out of the account. For example, the employee may choose to transfer the funds to another HSA trustee as soon as they are deposited.

- 2) The individual who establishes the HSA account is the owner of the account and is fully vested in his/her HSA account at all times. Individuals may use their account for family members (e.g., pay expenses for the spouse and tax dependents), but there are no joint accounts.
- 3) A source (or sources) of funding such as the account holder (e.g., employee), employer or both. There is no rule preventing another individual from contributing money to the HSA account; however, the annual contribution limits are based on aggregate contributions to the HSA (or all HSAs if the individual has more than one). In addition, only the employer or account holder may make contributions on a tax-deductible basis.

Note: Contributions to an HSA account (except rollovers from another HSA) must be made in cash.

- 4) Investment rules apply. There are some restrictions on how the account is invested (e.g., no portion of the account may be invested in life insurance products); earnings on contributions accumulate tax-free within the account; and contributions and earnings carry forward from year to year (there is no use-it-or-lose-it rule or limit on a carryover amount).

### Annual HSA Contribution Limits

Four types of rules govern the amount that can be contributed to an individual's HSA account each year:

- 1) General rules;
- 2) Special rules for families and domestic partners;
- 3) Rules for mid-year eligibility; and
- 4) Rules for employer contributions.

## ***General Rules***

The aggregate amount that can be contributed to an HSA (or HSAs) in any given year is based on the individual's age, coverage status under the HDHP, and the annual statutory limit (indexed each year). The statutory limits are shown in the Appendix. Two additional rules apply:

- 1) The catch-up amount applies separately to each HSA account holder. If both the employee and spouse are eligible to make catch up contributions, each must make the catch-up contribution to his/her own account. (There are no joint HSA accounts.)
- 2) Contribution limits are calculated on a monthly basis. There is a special rule for individuals who become HDHP eligible during the year (see section on part year enrollment). If the maximum annual contribution is \$6,550, the maximum monthly contribution is \$545.83.

## ***Special Rules for Families***

Special rules apply to contributions for married couples if either spouse has family HDHP coverage. The special rules for spouses do not apply to domestic or civil union partners (see the section "Domestic and Civil Union Partners"). In general:

- If either spouse has family HDHP coverage, both spouses are treated as having family coverage.
- If both spouses have HDHPs, the maximum family contribution will be split 50/50 between them unless they agree to a different allocation.
- The catch-up rule applies only to the HSA account holder

There are several family situations where the calculation of the maximum allowable contribution is more complex:

- 1) Both spouses have HDHPs
- 2) One spouse has an HDHP, the other a non-HDHP health plan
- 3) Additional rules when spouse excluded and for mid-year changes
- 4) Special rules for domestic and civil union partners

The examples that follow show how the maximum annual contribution amount is calculated. These examples assume that the annual maximum statutory contributions are \$3,350 single and \$6,750 family.

### **Both Spouses Have HDHPs**

- a) Both spouses have single HDHPs through their employers.

John (age 35) and Amy (age 32) are married. Both have single coverage under an HDHP with their employers. John has single coverage under a \$1,300 HDHP plan; Amy has single coverage under a \$1,500 deductible HDHP. Each may contribute up to \$3,350 to an HSA.

- b) Both spouses have family HDHPs through their employers.

Jane and Don are married. Jane has family coverage under a \$5,000 HDHP. Don has family coverage under a \$3,000 HDHP.



Annual statutory limit:	\$6,750
Jane's portion (50%):	\$3,375
Dave's portion (50%):	\$3,375

- c) Both spouses have family HDHPs through their employers; one spouse is eligible to make a catch-up contribution.

Ann and Dave are married. Ann is 53 and has family coverage under a \$2,600 HDHP. Dave is 58 and has family coverage under a \$3,000 HDHP.

Ann may contribute \$3,375.

Annual statutory limit:	\$6,750
Pro-rated 50%:	\$3,375

Dave may contribute \$3,375.

Annual statutory limit:	\$6,750
Pro-rated 50%:	\$3,375
Catch-up amount:	\$1,000
Annual contribution limit:	\$4,375

- d) Both Spouses Have HDHPs – One Family, One Single.

Judy and Adam are married. Judy has family coverage under a \$5,000 HDHP. Adam has single coverage under a \$2,000 HDHP.

Annual statutory limit:	\$6,750
Judy's portion (50%):	\$3,375
Adam's portion (50%):	\$3,375

Although Adam has a limit of \$3,350 with single HDHP and Judy has a limit of \$6,750 for family HDHP, their combined contribution cannot exceed the \$6,750 statutory limit for family HDHP.

### **One Spouse has an HDHP, Other has a non-HDHP**

- Andy and Martha are married. Andy has family coverage under a \$5,000 HDHP. Martha has single coverage under a PPO with a \$200 deductible (non-HDHP). Martha is not eligible to contribute to an HSA. Andy may establish an HSA. Andy's maximum contribution is \$6,750
- Beth and Carl are married. Beth has family coverage under a \$5,000 HDHP. Carl has family coverage under a \$500 deductible PPO. Neither Beth nor Carl is eligible to contribute to an HSA.
- Peter and Nancy are married. Peter is enrolled in Medicare. Nancy has family coverage under a \$5,000 HDHP. Nancy's maximum contribution is \$6,750 (assuming she is under age 55). Peter is **not** eligible to contribute to an HSA.

### ***Additional Rules – Excluded Spouse & Mid-Year Changes***

There are additional rules for situations where one spouse has family coverage that excludes the other spouse and where an individual's single/family coverage changes during the year.

**Family Coverage with an Excluded Spouse** – An employee whose spouse has family coverage under a non-HDHP health plan is not eligible to establish or contribute to an HSA unless the spouse's plan excludes the employee. The

exclusion under the spouse's plan must be contractual – included in the plan document and any insurance contracts. An agreement not to submit claims for one family member, for example, is not sufficient. Three examples (which assume annual maximum statutory contributions of \$3,350 single and \$6,750 family) follow:

- a) Andy has single coverage under an HDHP with a \$2,000 deductible. His wife Judy has family (parent and children) coverage under a non-HDHP health plan. Judy's family contract covers herself and their two children – George and Randy. Andy is **not** covered under Judy's plan.

Andy may establish a single HSA and contribute up to \$3,350. Judy is not eligible to establish or contribute to an HSA.

- b) Tom has family (parent and child) coverage under a \$5,000 deductible HDHP for himself and his daughter Nancy. His wife Tammy has family (parent and child) coverage under a non-HDHP plan for herself and her son Timmy.

Tom may establish a family HSA and contribute up to \$6,750. Tammy is not eligible to establish or contribute to an HSA.

- c) Molly has family (parent and child) coverage under a \$5,000 deductible HDHP for herself and her two children. Her plan does not cover her husband Rick. Rick does not have other health insurance.

Molly may establish a family HSA and contribute up to \$6,750. Rick is not eligible to establish or contribute to an HSA since he is not covered under an HDHP.

Note: Many (if not most) current plans would need to be amended to permit the employee to exclude a specific individual. Insurance company contract provisions and underwriting rules may limit the employee's ability to cover selected family members.

**Mixed Single/Family Coverage During the Year** – Individuals who are HSA eligible for the full year, but change from single to family (or family to single status) will need to pro-rate the contribution amount. For example:

Tom is covered under a single HDHP. Tom gets married at the end of March and changes his coverage to family HDHP on April 1. Cindy drops her old coverage when she becomes covered under Tom's plan. Tom's maximum contribution (based on statutory maximums of \$3,350 and \$6,750) would be:

\$3,350/12 x 3 (3 months of single coverage)	\$837.50
\$6,750/12 x 9 (9 months of family coverage)	<u>\$5,062.50</u>
Total	\$5,900

## Domestic and Civil Union Partners

Special rules apply for domestic and civil union partners – for both HSA contributions and HSA distributions. How the rules work depends on whether the domestic or civil union partner is a tax dependent of the employee.

### ***Tax Dependent***

The maximum allowable contribution for the employee (HSA account holder) will depend on the level of HDHP coverage. An employee who has single HDHP coverage may contribute up to the single maximum. An employee who has family coverage (e.g., covers himself and his domestic or civil union partner) may contribute up to the family maximum. Since the domestic or civil union partner is a tax dependent, HSA distributions for qualified medical expenses for the domestic or civil union partner will be tax-free (i.e., qualified distributions). The domestic

or civil union partner would not be eligible to contribute to an HSA since he could be claimed as a dependent on the employee's tax return.

### ***Non-Tax Dependent***

The maximum allowable contribution for the employee (HSA account holder) will depend on the level of HDHP coverage. An employee who has single HDHP coverage may contribute up to the single maximum. An employee who has family coverage (e.g., covers himself and his domestic or civil union partner) may contribute up to the family maximum.

In addition, if both domestic or civil union partners have HDHP plans, both may contribute up to the single or family maximum based on their level of HDHP coverage.

Because domestic or civil union partners are not spouses under federal law, the rule that the family limit must be split between spouses does not apply. If two spouses have family HDHP coverage, they must split the family maximum (\$6,750 for 2016) between them. If both domestic or civil union partners have family HDHPs, then each would be able to contribute up to the family limit.

However, since the domestic or civil union partner is not a tax dependent, HSA distributions from the employee's HSA to pay for medical expenses for the domestic or civil union partner will be nonqualified distributions includable in income and subject to the 20% penalty.

### **Partial Year HSA Eligibility**

There is a special rule for individuals who gain HSA eligibility during the calendar year. These individuals may choose to contribute the maximum for the calendar year rather than a pro-rated amount based on the number of months of HSA eligibility. The no-proration rule may be used for single, family and catch-up contributions. Two rules apply if the HSA contribution is not pro-rated: (1) the individual must be HSA eligible during the last month of the year (December) and (2) the individual must remain HSA eligible during a 13 month "testing period" (December of the current year plus the next calendar year). Here is how the rule works (based on statutory maximums of \$3,350 and \$6,750):

Sally is hired in June and becomes HSA eligible on July 1, 2016. Sally selects single HDHP for July 1. She contributes \$3,350 to her HSA. Sally is HSA eligible in December and for every month in the following calendar year.

Mary is also hired in June and becomes HSA eligible on July 1, 2016. Mary selects single HDHP for July 1. She contributes \$3,350 to her HSA. Mary is HSA eligible in December, but loses her HSA eligibility on the following July 1. Because Mary did not remain HSA eligible during the entire testing period (December plus the following calendar year), the \$1,675 additional contribution she made (\$3,350 full amount minus \$1,675 for 6 months):

- Is includable in her 2016 income\*
- Is subject to the 20% penalty \*

\*Exception for disability or death.

This rule is only available to individuals who become HSA eligible during the plan year (and continue to be HSA eligible during the testing period). Individuals who lose HSA eligibility during the year are limited to the pro-rated

amount. For example, if Adam becomes HSA eligible on March 1 but loses his HSA eligibility on October 31, he is only eligible for 8 months and can only contribute up to 8/12 of the HSA maximum.

## Accelerated Contributions

Employers are permitted to “accelerate” HSA funding – up to the maximum amount elected by the employee under the cafeteria plan to cover incurred qualified medical expenses – as long as:

- The employee has elected to make HSA contributions through a cafeteria plan
- Accelerated funding is available to all participating employees on the same terms throughout the plan year and
- The employee is required to repay the amount advanced by the end of the plan year.

Note: Regulations provide rules for accelerating an employer’s contribution outside a cafeteria plan (see Comparability section).

## Effect of PPACA on Contribution Levels

### *Minimum Value Calculation*

Beginning in 2015, employers with 50 or more full-time (and full-time equivalent) employees are subject to the Employer Mandate where they could face potential penalties if they do not offer minimum essential coverage that provides minimum value. Under current guidance, a portion of the amount an employer contributes to HSAs (in conjunction with a HDHP) may be included when determining whether the employer has met the “minimum value” requirement. The Minimum Value calculator provided by the regulators in 2013 is structured to include the value of the employer’s contribution once the employer enters the annual dollar amount of the annual contribution into the worksheet.

### *Cadillac Tax*

Beginning in 2018, the Cadillac plan tax which is a nondeductible excise tax will be imposed on high cost employer-sponsored health coverage. The Cadillac tax imposes a 40% excise tax on any excess benefit provided to an employee. An excess benefit is the excess (if any) of the aggregate cost of the applicable coverage of the employee for the month over the applicable dollar limit for the employee for the month. Baseline dollar limits for 2018 are \$10,200 per employee for self-only coverage and \$27,500 per employee for other-than-self-only coverage. There are also a few limited adjustments permitted such as for specified high risk occupations and retirees. These numbers will be indexed in future years. The cost of the applicable coverage will be determined under rules that are similar to those used to determine the COBRA applicable premium.

In proposed regulations, the IRS indicated that future regulations will include employer contributions and employee salary reduction contributions to HSAs towards the Cadillac tax’s applicable coverage limit. Employee after-tax contributions to HSAs will be excluded from applicable coverage. Maximum contributions to an HSA for 2016 will be \$3,350 self-only, \$6,750 other than self-only coverage and \$1,000 catch up for individuals 55 and older. Except for the \$1,000 catch-up, these amounts are indexed each year and are expected to be higher in 2018. The need to include employer contributions and/or employee salary reduction amounts when counting up the cost of health care

and comparing it to the applicable dollar amount for the “Cadillac Plan” tax will increase the likelihood of a plan being exposed to an excise tax.

## COMPARABILITY RULES

### Employer Contributions

HSAs may be established by eligible individuals without any employer involvement. If the employer offers a qualified HDHP, the employee who enrolls in the HDHP can establish an HSA on his/her own. In some cases, employers may want to take a stronger role and contribute funds to the HSA of an employee who selects HDHP coverage.

One of two sets of rules will apply to employer contributions:

- Comparability rules; and
- Cafeteria plan rules.

Each of these two sets of rules is described in more detail in the sections that follow. Employer contributions made through a cafeteria plan and employee pre-tax contributions are subject to the cafeteria plan rules, not the comparability rules. Cafeteria plan rules are in the next section. Employee after-tax contributions are not subject to either the comparability or the cafeteria plan rules.

This section contains rules for employer contributions made outside of a cafeteria plan.

### General Rules

An employer who makes contributions to the HSA account of any employee is required to make comparable contributions to the HSA accounts of all comparable, participating, HSA eligible employees (each of these terms is described in more detail below). Eligibility is based on the individual's status on the first day of the month, regardless of any change in status that occurs later in the month. Comparability applies on a monthly basis, however, testing is done on a calendar year basis.

If the employer does not satisfy this rule, the employer will owe an excise tax equal to 35% of the aggregate amount it contributed to all HSAs accounts for the entire calendar year. Comparable, participating HSA eligible employees are described in more detail in the sections that follow.

### Employees

The comparability rules only apply to employees. Comparability rules do not apply to partners, sole proprietors, or 2% shareholders in a Subchapter S corporation. (*See the Appendix for IRS guidance on partners and Subchapter S shareholders.*)

Here is an example for an employer who is a sole proprietor with two employees.

Bob's Business	HSA Contributions
Bob (Sole Proprietor)	\$1,000
Joe (Employee)	\$500
Ann (Employee)	\$500

This plan satisfies the comparability rules since all employees receive the same HSA contribution from the employer. Contributions a sole proprietor makes to his own account are not subject to the comparability rules.

The comparability rules apply to all employees of the employer on a **controlled group basis (IRC definition)**. The rules apply separately by employee category. Only three categories of employees are recognized:

- 1) Full-time employees (30 hours or more)
- 2) Part-time employees (less than 30 hours)
- 3) Former employees (excluding COBRA continuees)

There are **two exceptions** to this rule:

- 1) Union employees are excluded from comparability rules and testing as long as benefits were the subject of good faith bargaining.
- 2) Employers may provide a lower or no contribution for highly compensated employees [IRC 414(q) definition].

Differences are **not** permitted for classification such as:

- Management
- Salaried
- Specific locations (e.g., a particular plant or state)
- Specific sub-groups (e.g., a particular division).

For example, ABC organization has an HDHP covering all full-time employees – both management and non-management. If ABC contributes \$1,000 to the HSA of management employees covered under its HDHP, it must also contribute \$1,000 to the HSA of its non-management employees covered under its HDHP.

### ***Comparable Employees***

Comparable employees are employees in the same category (full-time, part-time, and former) who have the same level of HDHP coverage. Employers may use up to four levels of coverage:

- 1) Single (self only);
- 2) Employee and 1 Dependent;
- 3) Employee and 2 Dependents; and
- 4) Employee and 3 or More Dependents.

Note: While the employer may use up to four levels for contributions, there are only two levels for deductibles and out-of-pocket levels.

Contributions are comparable only if calculated using one of two methods:

- 1) Same dollar amount by coverage level; or
- 2) Same percentage of the HDHP deductible.

Contributions may vary by dependent levels as long as the employer contribution to a category with more dependents is not lower than a category with fewer dependents.



For example:

Coverage Level	Scenario 1 (acceptable)	Scenario 2 (not acceptable)
Employee and 1 Dependent	\$500	\$1,000
Employee and 2 Dependents	\$750	\$750
Employee and 3 Dependents	\$1,000	\$500

Employers must make pro-rata contributions for employees who are eligible for less than the full year. For example, if the employer contributes \$1,000 for the full year, the employer must contribute \$500 to an employee who is HSA eligible for 6 months.

The employer may contribute a different amount for part-time employees (or make no contribution for part-time employees). The amount contributed must be the same for all part-time employees – either a dollar amount by coverage level or a percentage of the HDHP deductible. The amount selected does not have to be a ratio based on the number of hours worked compared to full-time hours.

Note: Employers are prohibited from modifying their HSA contributions to reflect other factors such as wellness, health assessments or disease management programs, age (including catch up contributions), or service. Nor are matching contributions permitted. Some of these methods may be permitted if the HSA is part of a cafeteria plan.

Several comparable contribution scenarios are described below.

**Scenario #1:** ABC Organization has an HDHP with a \$2,100 single deductible and \$4,200 family deductible. ABC contributes \$1,000 to the HSA of any employee who elects coverage under its HDHP – single or family. ABC's contributions satisfy the comparability rule.

**Scenario #2:** ABC Organization has an HDHP with a \$2,100 single deductible and \$4,200 family deductible. ABC contributes \$1,000 to the HSA of any employee who elects family coverage under its HDHP. ABC does not contribute to the HSA of any employee who elects single coverage. ABC's contributions satisfy the comparability rule.

**Scenario #3:** ABC Organization offers employees a choice of two HDHPs and contributes to the HSA of employees who select either HDHP. ABC's HDHP plans are:

Deductibles	HDHP #1	HDHP #2
Single	\$2,000	\$2,500
Family	\$4,000	\$4,500

ABC decides to provide an HSA contribution of \$600 single and \$1,000 family for employees who select HDHP #1. In order to satisfy the comparability rule, ABC's contribution to the HSA of employees who select HDHP #2 must be either:

Coverage Level	Equal Dollar Amount	Equal Percentage
Single	\$600	\$750 (30%)
Family	\$1,000	\$1,125 (25%)

**Scenario #4:** ABC offers an HDHP with five coverage levels based on family status. ABC's HSA contributions based on these five categories are:

Coverage Level	HSA Contribution
Single	\$750
Employee + 1 Child (2 covered)	\$1,000
Employee + Spouse (2 covered)	\$1,000
Employee + Spouse + Child (3 covered)	\$1,500
Employee + Spouse + 2 or more Children (4 covered)	\$2,000

ABC's HSA contributions satisfy the comparability rules.

An employer may use up to four levels of contribution. For example, assume that ABC has a high deductible plan with deductibles of \$1,500 single, \$3,000 for two person (employee + 1 dependent) and \$4,500 for family (employee +2 or more dependents). Several permissible contribution structures are:

Coverage Level	Deductible	Permissible Designs		
		#1 (Flat Dollar Amount)	#2 (Percentage of Deductible)	#3 (Flat Dollar Amount)
Single	\$1,500	\$700	\$750	\$750
Two Person	\$3,000	\$1,000	\$1,500	\$1,500
Family	\$4,500	\$1,000	\$2,250	\$2,000

Employers have considerable flexibility in plan design. The regulations do, however, require the same amount or increasing amounts as the number of dependents increases.

## Participating in an HDHP

Employers who make HSA contributions are only required to make an HSA contribution to employees who are participating in an HDHP. The employer may limit its contribution to employees participating in its own HDHP (rather than a HDHP such as a spouse's employer's plan or an individual plan).

- If the employer makes contributions to HSAs of employees participating in its own HDHP (but not other HDHPs), the employer must make a comparable contribution to the HSA of all comparable, participating employees with coverage under any of its own HDHPs.
- If the employer makes a contribution to the HSA of any employee who is covered under another HDHP (e.g., under the spouse's plan through another employer), the employer must make a comparable contribution to the HSA of all comparable, participating employees with coverage under any HDHP.

**Scenario #1:** ABC Organization offers employees a choice of an HMO, a PPO with a \$500 deductible or an HDHP with a \$1,500 deductible. John selects single coverage under ABC's HDHP. Marie declines medical because she has coverage under her husband's plan (her husband's plan is an HDHP so Marie is HSA eligible). ABC decides to contribute \$500 to the HSAs of employees who take ABC's HDHP. ABC contributes \$500 to John's HSA, but not Marie's. ABC's contribution satisfies the comparability rule. ABC is permitted to limit HSA contributions to employees who elect coverage under ABC's HDHP.

**Scenario #2:** ABC Organization offers employees a choice of an HMO, a PPO with a \$500 deductible, and an HDHP with a \$1,500 deductible. ABC contributes \$500 to the HSA of employees who select its HDHP plan. One of ABC's full-time employees – Janet – does not have coverage under ABC's HDHP. Janet does have coverage under an HDHP with a \$2,000 deductible through her spouse's employer. ABC decides to contribute \$500 to Janet's HSA since she has an HDHP through her spouse and is HSA eligible. Since ABC is making an HSA contribution to one employee who is covered under a non-ABC HDHP, ABC must make a comparable contribution to the HSA of **any** comparable employee who is covered under a non-ABC HDHP.

## HSA Eligible

HSA contributions are only permitted for individuals who are HSA eligible. Comparable contributions do not apply to employees who are ineligible for an HSA.

**Scenario #1:** ABC Organization provides the following medical plans to its full-time employees:

Employee Class	Medical Plan
Management Employees	\$1,500/\$3,000 HDHP
Non-Management Employees	\$500 Deductible

ABC's HSA contributions are:

Employee Class	Single	Family
Management Employees	\$750	\$1,500
Non-Management Employees	\$0	\$0

ABC's plan satisfies the comparability rule. ABC is not required to contribute (and in fact cannot) for non-management employees since the non-management employees are not HSA eligible (they have health coverage under a plan that is not a qualified HDHP).

If ABC has a different HDHP for non-management employees – for example, an HDHP with deductibles of \$2,000 single and \$4,000 family – ABC must make comparable contributions to the non-management employees' HSAs.

**Scenario #2:** ABC offers an HDHP and a general purpose FSA (the FSA reimburses medical, drug, dental and vision expenses). The FSA does not have a deductible. ABC has four employees who enroll in its HDHP. ABC will contribute \$500 to all comparable, participating HSA eligible employees. The chart below shows ABC's required contribution to HSA accounts based on each employee's participation status.

Employee	Participation	Required HSA Contribution
Dan	<ul style="list-style-type: none"> <li>ABC's HDHP</li> </ul>	\$500
Marilyn	<ul style="list-style-type: none"> <li>ABC's HDHP</li> <li>ABC's FSA</li> </ul>	\$0
Jim	<ul style="list-style-type: none"> <li>ABC's HDHP</li> <li>Spouse's FSA</li> </ul>	\$0
Ginny	<ul style="list-style-type: none"> <li>ABC's HDHP</li> <li>Medicare (enrolled)</li> </ul>	\$0

Although all four employees are enrolled in ABC's HDHP, only Dan is HSA eligible. Marilyn and Jim are not HSA eligible since they are enrolled in a health plan that is not a qualified HDHP (the general purpose FSA). Ginny is not eligible since she is entitled to (enrolled in) Medicare. ABC's \$500 contribution to Dan's HSA account satisfies the comparability rule.

## ***Special Situations***

### **Husband & Wife Employees**

A special rule applies when two married employees work for the same employer. If the employer makes HSA contributions only to employees who are covered as employees under its own HDHP, then the employer is not required to contribute to the HSA of an employee spouse who is covered only as a dependent under its HDHP.

Here is an example:

Jim & Sarah are married and have one child – Amy. Both work for ABC Organization. Jim takes family coverage (covers Jim, Sarah and Amy). Sarah waives coverage. ABC contributes to employee HSAs -- \$500 for single and \$1,000 for family. ABC does not contribute to the HSA of any employee covered under a non-ABC HDHP.

ABC contributes \$1,000 to Jim's HSA since he has family coverage under ABC's HDHP. ABC makes no contribution for Sarah since she does not have ABC's HDHP coverage. ABC's contribution satisfies the comparability rule.

If the employer does not limit HSA contributions to eligible employees who are enrolled in the employer's HDHP (as employees), then the employer must make comparable contributions to all comparable, participating, HSA eligible employees. Here is an example:

Jim & Sarah are married and have one child – Amy. Both work for ABC Organization. Jim takes family coverage (covers Jim, Sarah and Amy). Sarah waives coverage. ABC contributes to employee HSAs -- \$500 for single and \$1,000 for family. ABC also contributes \$500 to the HSA of any employee covered under a non-ABC HDHP (e.g., a spouse's employer's HDHP).

ABC contributes \$1,000 to Jim's HSA since he has family coverage. ABC must contribute \$500 for Sarah (to Sarah's HSA) since ABC contributes to the HSA of other employees who did not select ABC's HDHP (they must still be HSA eligible).

### **Former Employees**

Employers are permitted to contribute to the HSA accounts of former employees who are HSA eligible. Contributions may be limited to former employees who are covered under the employer's HDHP and may be different from contributions for current employees.

Contributions are not required for individuals whose coverage as a former employee is based on a COBRA election. For example:

Employee Category	ABC's HSA Contribution
<b>Full-Time Employees</b>	
Single	\$750
Family	\$1,000

Employee Category	ABC's HSA Contribution
<b>COBRA Participants</b>	
Single	\$0
Family	\$0
<b>Former Employees</b>	
Single	\$300
Family	\$400

Employers may limit contributions for former employees to those who are covered under the employer's HDHP. Two rules apply.

**Rule #1 (Employer's HDHP):** If the employer contributes to the HSA of any former employee covered under any of its HDHPs, it must contribute to the HSA of all comparable, participating, HSA eligible former employees covered under any of its HDHPs. For example:

ABC Organization provides coverage to its salaried and hourly retirees. Salaried retirees may choose either a \$2,000 HDHP or a PPO plan with a \$500 in-network deductible. ABC decides to contribute \$500 to the HSA of salaried retirees who elect the \$2,000 HDHP plan. Hourly retirees are only eligible for a \$1,500 HDHP.

- ABC is not required to contribute to salaried retirees who elect the \$500 PPO plan (in fact, ABC cannot contribute since these retirees are not HSA eligible because they have non-HDHP coverage).
- ABC must contribute to the HSAs of hourly retirees who select the \$1,500 HDHP. ABC must contribute either \$500 (the same dollar amount) or the same percentage of the deductible – \$375 ( $\$500/\$2,000 = 25\%$  of deductible x \$1,500 hourly retiree deductible).

**Rule #2 (Any HDHP):** If the employer contributes to the HSA of any former employee who is covered under an HDHP that is not the employer's, the employer must contribute to the HSA of all comparable, participating, HSA eligible former employees. For example:

ABC Organization provides coverage to its retirees under either a \$2,000 HDHP or a PPO plan with a \$400 in-network deductible. ABC decides to contribute \$750 to the HSA of retirees who have coverage under an HDHP – either ABC's HDHP or another HDHP (such as a spouse's employer's plan). ABC has four former employees eligible for retiree medical:

Retiree	Medical Plan Coverage	Required HSA Contribution
Andy	ABC PPO	\$0
Cindy	ABC \$2,000 HDHP	\$750
Joe	No ABC coverage \$2,000 HDHP with spouse's employer	\$750
Wayne	No ABC coverage, PPO with \$300 deductible with spouse's employer	\$0
Sue	ABC \$2,000 HDHP (COBRA)	\$0

ABC must make comparable contributions for Cindy and Joe who are covered under HDHPs. No contributions are required for Andy or Wayne since they are both ineligible for an HSA. Sue does not get contributions because her HDHP coverage is COBRA continuation coverage.

Since employer contributions for an HSA must be cash contributions to an HSA account, making contributions to former employees who are not covered under the employer's HDHP may create practical concerns such as determining if/when the employee becomes ineligible and keeping track of the former employee's HSA.

Employers making comparable contributions to former employees must take reasonable steps to locate missing former employees using any of the following:

- 1) Certified mail;
- 2) IRS letter forwarding program; or
- 3) Social Security Administration letter forwarding program.

Employers who do not restrict their HSA contributions to former employees covered under their own HDHP are more likely to experience problems locating former employees.

Note: Severance agreements may create comparability non-compliance. An employer who continues HSA contributions to an employee under a severance agreement will need to make a comparable contribution to all former employees who are HSA eligible.

## Potential Problem Areas

Three types of situations merit additional attention:

- 1) Employers who have several entities under a controlled group,
- 2) Employers who have different benefit plans in different locations, and
- 3) Plans with an employee plus child(ren) contribution level. Issues and examples follow.

### ***Controlled Group Rule***

Comparability rules apply on a controlled group basis – as defined in Internal Revenue Code Sections 414(b), 414(c), 414(m) and 414(o). If HSA contributions are made in any entity within the controlled group, the employer must make comparable contributions for comparable, participating, HSA eligible employees in all of the entities within the controlled group. For example:

ABC Company Inc. offers a \$2,400 deductible HDHP to its 4,000 employees. ABC contributes \$600 to the HSA of employees who select its \$2,400 HDHP. ABC also owns 82% of the stock of Jiffy Printing Company Inc. Jiffy Printing has 100 employees and offers a choice between an HMO and a \$1,300 deductible HDHP.

Jiffy Printing must contribute to the HSA of its employees who select the \$1,300 HDHP, unless the employee is HSA ineligible (e.g., the employee selects the HMO). Jiffy Printing would be required to contribute either \$600 (the same dollar amount) or the same percentage of the deductible ( $\$600 / \$2,400 = 25\%$  x  $\$1,300 = \$325$ ).

### ***Different Locations or Classes***

Employers who are a single entity – not part of a controlled group – still need to be concerned about benefit structures that vary by location or class.



**Example #1:** ABC has locations in Texas, Florida and Georgia. The Texas location offers a \$1,500 HDHP. Florida only offers a PPO with a \$700 deductible. Georgia has a choice between a \$1,500 HDHP and a PPO. If the employer makes HSA contributions to Georgia employees, it must make comparable contributions (same dollar or percentage of the deductible) in Texas.

**Example #2:** ABC has 600 salaried employees and 4,000 hourly employees. Salaried employees have a choice between a \$1,500 HDHP and a PPO with a \$750 deductible. Hourly employees have a \$3,000 HDHP. ABC contributes \$750 to the HSA of salaried employees who select the HDHP. ABC must contribute to the HSA of hourly employees – either the same dollar amount \$750 or the same percentage of the deductible ( $\$750/\$1,500=50\% \times \$3,000 = \$1,500$ ).

A similar problem could arise when an employer has multiple divisions or subsidiaries. For example:

Subsidiary	HDHP
#1	\$2,000/\$4,000
#2	\$1,500/\$3,000
#3	\$3,000/\$6,000

Employees in each of these three subsidiaries must receive the same dollar contribution to the HSA or the same percentage of the deductible (single and family percentages may be different).

In the above example, giving \$1,000 per employee to Subsidiaries 1 and 3 but only \$500 for Subsidiary 2 would violate the comparability rule and the employer will be required to pay the 35% excise tax for all HSA contributions made in the controlled group.

### ***Family Coverage Levels***

Few employers would design a plan to give an employee with three dependents a lower contribution than an employee with one dependent. Some will give the same contribution to all family units regardless of size. Others will provide larger amounts to employees with more dependents. For example, an employee might give \$500 to the employee with one dependent and \$1,000 to an employee with two or more dependents (but not the reverse). There is, however, one contribution structure that could inadvertently create a problem – a plan with a coverage category of children. For example:

Coverage Level	IRS Category
Single	Single
Employee and Spouse	Employee + 1 Dependent
Employee and 1 Child	Employee + 1 Dependent
Employee and Spouse and 2 Children	Employee + 3 Dependents
Employee and 2 Children	Employee + 2 Dependents
Employee and Spouse and Children	Employee + 3 Dependents
Employee and 3 Children	Employee + 3 Dependents



Employers are not required to restructure their plans (i.e., deductibles, employee contributions, etc.), but the amount the employer contributes to the employee's HSA needs to be designed to satisfy the comparability rule based on the IRS categories. For example, assume an employer has the following plan design:

Category	Deductible	ABC's HSA Contribution
Single	\$2,000	\$500
Employee & Children	\$3,000	\$1,000
Employee & Spouse	\$3,000	\$1,000
Family	\$5,000	\$2,000

While this type of structure may be reasonable, it will not satisfy the comparability test if an employee who has 3 children (4 individuals) gets \$1,000 while an employee with a spouse and one child (3 individuals) gets \$2,000.

## EMPLOYER FUNDING METHODS

Employers have a choice of three different funding methods for their HSA contributions. Once the employer has selected one of these three methods, it must be used for HSA contributions for all employees who will receive the employer contribution. Some modification is permitted for employees who are HSA eligible for less than the full year. The three funding methods are:

- Pay-as-you-go;
- Look-back; and
- Pre-fund.

All contributions to the HSA (excluding rollover amounts from another HSA) must be made in cash and all contributions are 100% vested immediately. Unlike HRAs, the HSA is not a “notional account”. Nor can the employer give/send the employee a check with instructions that the money is to be deposited into the employee’s HSA.

Each of these funding methods is described in more detail below.

### Pay-As-You-Go

If an employer contributes to employee’s HSA accounts on a pay-as-you-go basis:

- Contributions for all employees with the same category of coverage – full-time, part-time or former employees – must be made at the same time.
- Contributions may be made on a per pay cycle basis – even if different groups have different payroll cycles. For example, if salaried employees are paid monthly and hourly employees weekly, then HSA contributions may be made monthly for salaried and weekly for hourly.
- The level of contributions may be changed by the employer during the year.

**Example #1:** ABC has a calendar year HDHP and contributes \$50 per month on the first day of the month. ABC contributes toward HSAs from January through June, but stops HSA contributions for all employees on July 1. Comparable contributions for four sample employees with different hire or termination date are shown in the chart below.

Employee	Hire Date	Term Date	HSA Contribution
Donna	Prior to Jan. 1	Mar. 15	\$150 (Jan, Feb & Mar @\$50)
George	Apr. 15	N/A	\$100 (May & June @\$50)
Sally	Aug. 15	N/A	\$0
Sam	Prior to Jan. 1	N/A	\$300 (Jan through June @ \$50)

**Example #2:** ABC contributes \$50 per month to employees with single HDHP coverage and \$100 to employees with family coverage. Jane is single for the first 3 months of the year; she gets married on March 22 and changes to family coverage on April 1. ABC’s contribution to Jane’s HSA will be:

January, February & March	\$ 150 (3 x \$50)
April through December	<u>\$ 900 (9 x \$100)</u>
<b>Total</b>	<b>\$1,050</b>

## Look-Back Rules

If an employer contributes to employees' HSA accounts on a look back basis:

- Contributions may be made at the end of the plan year.
- Contributions must be made for all employees who were eligible for any month in the plan year.
- Adjustments must be made for those whose coverage level (i.e., single or family) changes during the year.

**Scenario 1:** ABC has a calendar year plan and contributes \$600 per year (\$50/month) for singles and \$1,200 per year (\$100/month) for families. Carla has family HDHP for the first 6 months of the year (January through June) and single coverage for the other 6 months (July through December). ABC's contribution to Carla's HSA at the end of the year will be \$900:

January through June	\$600 (\$100/month x 6 months)
July through December	<u>\$300 (\$50/month x 6 months)</u>
Total	\$900

**Scenario 2:** ABC contributes \$1,200 per year (\$100/month) to HSA accounts of eligible single employees. ABC has three employees with single HDHP/HSA coverage during the year.

Employee	Term Date	HSA
Alan	N/A	\$1,200
Pat	June 15	\$600 (\$100 per month x 6)
Bill	N/A	\$1,200

Note: ABC must contribute to Pat's HSA even though he has left ABC.

## Pre-Fund

Employers are permitted to fund HSA accounts at the beginning of the plan year (pre-fund). If an employer contributes to employees' HSA accounts on a pre-fund basis:

- The entire amount may be contributed at the beginning of the year.
- Amounts contributed cannot be "recouped" by the employer if the employee leaves or otherwise becomes HSA ineligible during the year.
- Comparable contributions must be made for all employees who are HSA eligible for any month during the year.

Contributions for individuals hired during the plan year may be made using a pay-as-you go, look-back or pre-fund methods. The same method must be used for all employees hired during the year.

ABC pre-funds \$1,200 for the calendar year to HSA eligible employees. A new employee – Mike – is hired in May and becomes HSA eligible on June 1. ABC has three options for contributing to Mike's HSA:

- 1) Contribute \$700 in June (7 months pre-funded);
- 2) Contribute \$100/month for June through December (pay-as-you-go); or
- 3) Contribute \$700 at the end of the year (look-back)

Once ABC has selected one of the above methods, it must be used for all employees hired during the year.

## Other Funding Rules

Note: Pre-funding can lead to excess contributions.

Regulations provide additional guidance in three areas: (1) comparable contributions required when the employee has not established (or advised the employer that he has established) an HSA by the end of the calendar year; (2) rules for accelerating contributions; and (3) the appropriate rounding method.

### ***HSA Not Established***

Contributions to an employee's HSA may need to be delayed if the employee has not established an HSA by the date on which the contribution is due. For example, if an employer makes monthly contributions and one employee does not establish his account until March, the employer contributions for January and February cannot be made before March. IRS rules give the employer considerable flexibility in the timing of these delayed contributions. The employer may make these contributions at any time between the date the HSA is established and the individual's tax filing deadline for that year. For example, if the employer has a calendar year plan for 2016 and the employee initially sets up his HSA on March 1, 2016 the employer may make January and February 2016 contributions anytime between March 1, 2016 and April 17, 2017 (because April 15 is a Saturday).

Where an employee has either not established an HSA by December 31 or has not notified the employer that the HSA has been established, the employer must provide the employee with an appropriate notice before the following January 15. The notice advises the employee that he needs to establish an HSA and provide the employer with needed information by the end of February in order to receive the employer's contribution (regulations include sample notice language). If the employee establishes an HSA and gives the necessary information to the employer by the end of February, the employer has until April 15 to make the contribution to the employee's HSA. If the employee does not establish the HSA and notify the employer by the end of February, no employer contribution is required for that year.

### ***Accelerated Contributions***

Regulations permit an employer to accelerate its contributions to the HSAs of employees who during the calendar year incur qualified medical expenses that exceed the employer's calendar year-to-date contributions. The employer may accelerate part or all of its contributions subject to the following rules:

- Accelerated contributions must be provided to all eligible employees on an equal and uniform basis.
- Common methods and requirements must be used to determine accelerated contributions.
- Common method must be used to determine qualified medical expenses.
- Same amount or percentage must be used for all eligible employees.

An employee who receives an accelerated contribution who terminates before the end of the year may receive a greater contribution on a monthly basis than employees who did not terminate before the end of the year.

### ***Mistaken Contributions***

Employers are generally not permitted to recover overpayments made to an employee's HSA. Examples of overpayments that may occur are individuals who lose eligibility during the year or who terminate employment under plans using pre-payment funding. This also applies if there is a delay between the date the employee loses eligibility and the date the employer is notified by the employee. For example, an employee is HSA eligible on 1/1, but loses

eligibility because of new coverage under the spouse's plan on 4/1. The employee first realizes his loss of HSA eligibility on 7/15 and notifies the employer on 7/15. The employer must stop contributions beginning on 7/15, but may not recover contributions made between 4/1 and 7/15.

There are two exceptions to the "no recoupment" rule. First, contributions to the HSA of an individual who was never HSA eligible (where the employer reasonably believed the individual was eligible). The employer may recoup the funds from the HSA trustee as long as the recovery is completed before the end of the year. The employer cannot recoup the mistaken payment after the end of the year. Mistakes discovered after the end of the year must be included on the employee's Form W-2 for the year in which the employer made the contributions.

Second, the employer makes a contribution that inadvertently exceeds the statutory maximum. Recovery of mistaken contributions is only permitted in the event the amount contributed exceeds the statutory maximum and only to the extent that it exceeds the maximum. The employer may not recover mistaken payments that are at or below the statutory maximum.

### ***Rounding***

Rounding must be done to the nearest 1/100<sup>th</sup> of a percentage and to the nearest whole dollar amount. For example, if the employer has a \$3,500 deductible plan and contributes an amount equal to 1/3 of the deductible, the dollar amount of the contribution will be \$1,167 (33.33% x \$3,500 rounded to the nearest whole dollar).

## **Remedies/Penalties for Excess Contributions**

Remedies and penalties for excess contributions for employers and individuals are described below.

### ***Employer Contributions***

An employer who makes an excess contribution into an employee's HSA may not recover the excess amount (unless the amount contributed exceeds the annual statutory maximum – \$3,350, single and \$6,750 family). For example, the employer pre-funds HSA accounts for employees and deposits \$1,200 into eligible employee accounts on January 2. One employee – Sam terminates employment at the end of January. The employer cannot recover the \$1,200 "excess" contribution it made to Sam's HSA account.

### ***Corrective Contributions***

An employer may make additional contributions in order to satisfy comparability. For example, ABC Corporation has eight employees who are comparable, participating, HSA eligible. All eight are covered under ABC's HDHP. During the year, ABC makes the following contributions:

7 Employees @ \$1,000 each	\$7,000
<u>Sam @ \$500</u>	<u>\$500</u>
Total HSA Contributions	\$7,500

Without an additional contribution to Sam's account, ABC will fail the comparability test and owe an excise tax of \$2,625 (35% of \$7,500). ABC is permitted to make an additional contribution to Sam's account – \$500 **plus** a reasonable amount of interest – in order to pass the comparability test. The additional contribution must be made by the tax filing date (e.g., April 15, of the year following the calendar year).

## ***Penalty***

Where an employer does not make comparable contributions, the penalty is a 35% excise tax. For example:

ABC has a \$2,000 HDHP and made HSA contributions for eight single employees for the calendar year:

2 employees (officers) @ \$2,000 each	=	\$ 4,000
6 employees (non-officers) @ \$1,000 each	=	\$ 6,000
		<u>\$10,000</u>

ABC's HSA contributions fail the comparability test. ABC will have an excise tax of \$3,500 (35% of \$10,000).

## ***Individual Contributions***

An individual may have excess contributions based on an employer contribution (e.g., an employee loses HSA eligibility during the year where the employer pre-funds HSAs) or based on her own contribution. The individual must remove the excess contributions, plus earnings by the tax filing date (generally April 15) or pay a 6% excise tax on the excess contributions (including earnings on the excess amount).

Excess employer contributions removed by the tax filing date will be taxable as income, but will not be subject to the 6% excise tax.

## CAFETERIA PLANS

Either or both the HDHP and HSA account can be funded through a cafeteria plan. HSAs that are part of a cafeteria plan are not subject to the comparability rules but must satisfy cafeteria plan nondiscrimination requirements. (Note: Only employees can participate in a cafeteria plan.) Employer contributions toward an employee's HSA offered under a cafeteria plan will generally be in one of three forms:

- 1) Salary reductions;
- 2) Employer flex credits; and/or
- 3) Employer non-credit contributions such as:
  - Flat dollar amount
  - Specified percentage of deductible(s)
  - Matching contributions.

An employer's contribution toward an employee's HSA may not be considered to be "through" a cafeteria plan if the contribution is non-elective and non-cashable. The IRS proposed regulations included the following example:

ABC Organization sponsors a cafeteria plan and provides a HDHP under the cafeteria plan. ABC contributes \$300 to the HSA of every employee who selects its HDHP, and only to those employees. ABC's \$300 contribution is only to fund the HSA, the employees are not permitted to take any of the \$300 in cash or use any of the \$300 to purchase other benefits. The IRS states that ABC's \$300 contribution is not through a cafeteria plan. Since it is not through a cafeteria plan, ABC's \$300 contribution is subject to the comparability rules.

Based on this example, just having HDHP with pre-tax contributions by itself is not enough to make the employer's contribution be "through" a cafeteria plan. At least one other element of choice is needed. The IRS has confirmed in the final regulations that the inclusion of a salary reduction feature would make employer contributions "through" a cafeteria plan. If the plan permits the employee to put his own money into the HSA (via salary reduction) in addition to the employer contribution, the employer contribution will be "through" a cafeteria plan.

In order to ensure that employer contributions are "through a cafeteria plan" and hence not subject to comparability rules, employers should design their plans to permit employees to:

- Contribute funds toward their HSAs using salary reduction (pre-tax money); or
- Use employer funds to purchase other benefits under the cafeteria plan or take cash (e.g., cashable credits); or
- Use employer HSA contributions to purchase other benefits such as dental or vision coverage with the employee's choice including at least one taxable benefit (e.g., group term life insurance or vacation days), but without a cash option (i.e., non-cashable credits).

While employer contributions under a cafeteria plan are not subject to comparability requirements, they are subject to the non-discrimination rules of Internal Revenue Code Section 125. The non-discrimination rules of IRC 105(h) do not apply to HSAs.



Most of the cafeteria plan rules apply, but election changes for an HSA must be permitted on a monthly (or more frequent) basis as long as the changes are prospective. (Changes to the HDHP follow the normal cafeteria plan rules). There are three cafeteria plan rules that do not apply to HSA accounts:

- 1) Prohibition against deferred compensation (funds can be rolled over into future years);
- 2) Uniform coverage rule (the maximum reimbursement does not need to be available during the entire plan year); and
- 3) Period of coverage (under the HSA) does not need to be 12 months in length.

Note: that while employees may be able to change HSA contributions during the year, the HDHP plan is subject to the IRS change in status rules. As a result, an employee may be able to change her HSA contributions, but not her HDHP election.

## INTERACTION OF HSAS AND FSAS

Individuals who are covered under a non-HDHP health care plan are not eligible for an HSA. If an employer introduces an HDHP/HSA plan during a plan year (e.g., July 1 where the employer has a calendar year health plan), an employee who has a general-purpose health care FSA would be able to change to the HDHP. However, the employee cannot establish or contribute to an HSA because she is HSA ineligible (she has a non-HDHP health plan). She cannot change her FSA election in order to become HSA eligible because cost and coverage change rules do not apply to health care FSAs.

Many FSA plans are general purpose FSAs which reimburse a wide variety of health care expenses (e.g., medical, drug, dental, vision expenses). These FSAs are non-HDHP health care plans. Individuals covered under one of these general purpose FSAs are not HSA eligible. There are several ways that an FSA can be structured to make it HSA compatible:

- **Limited purpose FSA** – the FSA only reimburses permitted benefits such as dental and vision expenses and/or preventive care.
- **High deductible FSA** – the FSA only reimburses health care expenses after a high deductible (the minimum amount required by law) has been satisfied. (Note: Only expenses covered under the HDHP may be counted toward the satisfaction of the deductible before the FSA begins to reimburse expenses.)
- **Employee only FSA** – if an FSA covers only the employee (not the spouse or dependents), only the employee would be ineligible for the HSA.

### FSA with Grace Period

An individual covered under an FSA with a grace period will not be eligible to contribute to an HSA until after the grace period has expired unless she has a \$0 balance on the last day of the year on a cash basis.

For example, an employee is covered under an FSA with a 2-month grace period in 2015. This employee would not be eligible to make HSA contributions during January or February of the following year (the grace period) even if she does not elect the FSA for 2016 unless she has no balance in her 2015 FSA account on December 31, 2015. Employers can modify their FSAs to eliminate this restriction by converting the FSA to a limited purpose or high deductible FSA during the grace period. The conversion must, however, apply to all FSA participants.

In future years, the employer may permit employees to choose between a general purpose FSA or an HSA-compatible HSA at enrollment – either annual enrollment before the plan year begins or initial enrollment for employees such as new hires who become eligible during the year.

### FSA with Carryover

Enrollment in a general purpose FSA with a carryover provision makes an individual ineligible to contribute to an HSA for the entire plan year. This includes an individual who has coverage under the general purpose health FSA only as the result of a carryover of an unused amount from the prior year. Under IRS guidance released in March 2014, there are three ways that an employer may structure their plan so that employees enrolled in a general purpose FSA with a carryover provision can preserve HSA eligibility for the following plan year:

- Permit employees enrolled in the general purpose health FSA to decline or waive the carryover of amounts to the next plan year. This waiver must be made before the next plan year begins.

- If the cafeteria plan offers both a general purpose and an HSA-compatible FSA, permit employees to enroll in an HSA-compatible FSA for the following year (employee must be HSA eligible) and carry over unused balances to the HSA-compatible FSA for following plan year. This election must be made before the plan year begins for the HSA-compatible FSA.
- If the cafeteria plan offers both a general purpose and an HSA-compatible FSA, when the employee enrolls in an HDHP for the following year automatically treat the employee as enrolled in the HSA-compatible FSA for the following year and transfer unused funds (up to the \$500 limit) to the HSA-compatible FSA.

## HSA DISTRIBUTIONS

An HSA account holder always has 100% ownership in the funds in his/her account. Neither the trustee, nor any employer who has contributed to the HSA, may restrict how the account holder uses these funds. For example, the account cannot be limited to payment of qualified expenses or “medical” rather than “dental” or “vision” expenses. Trustees are permitted to limit the number of withdrawals per month or require a minimum dollar amount for disbursements. For example, a trustee may require a minimum withdrawal of \$50 or allow only two withdrawals per month.

While the account holder is free to use the funds for any purpose, the use of the funds determines the tax status of the withdrawals. Funds withdrawn from an HSA account to pay “qualified expenses” are tax-free distributions. Funds used to pay “nonqualified” expenses are taxable and in many cases, an additional tax penalty will apply.

There are additional rules that are outside the scope of this guide. For example, an individual may not borrow funds from his HSA or use his HSA balance as collateral for a loan (these are prohibited transactions that would result in disqualification of the HSA).

### Withdrawals for Qualified Expenses

“Qualified expenses” are amounts used to pay deductible health expenses for the account holder, spouse and/or tax dependents of the account holder. (Note: Some domestic or civil union partners may qualify as tax dependents; others may not.)

The definition of a dependent used for determining what expenses are qualified under an HSA is different from the rules that apply to the underlying HDHP, HRAs, and health FSAs. PPACA changed the tax status of coverage for children (natural, adopted including placed, step and foster) so that their expenses may be reimbursed by an HDHP, HRA, or health FSA as long as the child is under age 27 at the end of the year. This broader definition does not apply to HSAs. Generally, children for HSA distributions are limited to children the individual can claim as tax dependents (or could claim except that the child earned more than a specified dollar amount — \$4,000 in 2015). IRS Publication #969 provides more detailed information.

Health care expenses includes: medical, drugs (both prescription and over-the-counter for which the individual has received a prescription), dental, vision, hearing, qualified long term care expenses [IRC 7702B(c)], and other health care expenses that are tax deductible and not reimbursed under another plan (e.g., a medical plan).

Qualified expenses also include premiums for the following specified plans and situations:

- COBRA premiums.
- Qualified Long Term Care policy premiums (up to specific dollar limits).
- Premiums paid for health coverage during a period of unemployment (individual must be receiving unemployment benefits under either federal or state law).
- Retiree health plan contributions – the amount a retiree (age 65 or older only) must pay for coverage under an employer’s retiree health plan.
- Medicare Part B, Part D and Medicare Advantage premiums for individuals age 65 or older (not individuals under 65 who have Medicare).

Medigap premiums are not qualified medical expenses.

The account holder may use funds from the HSA to cover qualified medical expenses that were incurred any time after the HSA account was established. (State trust laws generally determine the date on which the account is established. There is a special rule for individuals establishing a second HSA within an 18-month time frame.) HSA funds can be used to pay expenses for a prior year. For example:

Action	Date	Amount	HSA Balance
Establish HSA	1/1/15	\$100	\$100
Contribute to HSA for 2015	12/1/15	\$1,200	\$1,200
Incur Medical Expense	12/31/15	\$2,000	\$1,200
Contribute to HSA for 2016	12/1/16	\$1,200	\$2,400
Withdraw for Medical Expenses (12/31/15 expense)	12/15/16	\$2,000	\$400

The entire \$2,000 incurred in 2015 can be reimbursed from the account in 2016 even though the amount available on the date the expenses were incurred was less than the balance (\$1,200 HSA balance at the end of 2015; \$2,000 in 2015 expenses). Amounts incurred for medical expenses before the HSA was established on 1/1/15 – such as a \$300 charge in December 2014 – would not be qualified expenses.

Tax-free withdrawals may also be made for qualified expenses of the account holder or spouse or tax dependent of the HSA account holder even if the individual is not eligible to establish or contribute to an HSA.

**Example #1 Andrea's 2015 Medical Expenses:** In 2015, Sam and Andrea are married and have family HDHP coverage with a \$4,000 deductible through Sam's employer. Andrea also has single coverage under a PPO plan with a \$300 deductible with her employer. Andrea is not eligible to establish or contribute to an HSA in 2015. Sam may still use funds in his HSA to pay for Andrea's 2015 health care expenses that are not paid by another plan such as her PPO.

2015 Expense	Cost	PPO Paid	HDHP Paid	Unpaid
Office Visit	\$200	\$180	\$0	\$20
Rx (2 drugs)	\$100	\$80	\$0	\$20
X-Rays	\$200	\$160	\$0	\$40
<b>Total</b>	<b>\$500</b>	<b>\$420</b>	<b>\$0</b>	<b>\$80</b>

Sam may use \$80 from his HSA to pay Andrea's unpaid medical expenses. The \$80 HSA withdrawal is tax-free since it is for qualified expenses.

**Example #2 – Andrea and Sam's 2016 Medical Expenses:** In 2016, Sam and Andrea were married and had family HDHP coverage with a \$4,000 deductible through Sam's employer. January 1, 2016 Sam changes from the HDHP to a PPO plan with a \$300 deductible. Sam is not eligible to contribute to his HSA in 2016. Sam may still use funds in his HSA to pay for his and Andrea's 2016 health care expenses that are not paid by his PPO.

2016 Expense	Cost	PPO Paid	Unpaid
Sam - Office Visit	\$200	\$180	\$20
Sam - Rx Drugs	\$100	\$80	\$20
Andrea - Office Visit	\$200	\$180	\$20
Andrea – X-Ray	\$200	\$160	\$40
<b>Total</b>	<b>\$700</b>	<b>\$600</b>	<b>\$100</b>

Sam may use \$100 from his HSA to pay his and Andrea’s unpaid medical expenses. The \$100 HSA withdrawal is tax-free since it is for qualified expenses.

The account holder is responsible for determining if his/her request for funds is a qualified withdrawal. The account holder also has the responsibility to maintain the appropriate records to substantiate the type of withdrawal if requested by the IRS (e.g., during an IRS audit).

Regulations do not specify an ordering sequence for HSAs and other plans (e.g., HRAs and FSAs). The individual may not, however, have an expense paid by more than one plan (e.g., a \$300 medical bill paid by both an FSA and an HSA).

## NONQUALIFIED WITHDRAWALS

Any withdrawal of funds from an HSA that is not used for a qualified expense is a nonqualified withdrawal. Examples of nonqualified withdrawals include payment for health care expenses that are not deductible (e.g., cosmetic treatments), payment of Medigap premiums, payment of health care contributions under an employer's retiree health care plan for an individual under age 65, or to pay for a cruise. Payment of health care expenses for a non-tax dependent (e.g., domestic or civil union partner who is not a tax dependent) is also a nonqualified withdrawal. Nonqualified withdrawals are taxable income to the account holder. In addition, a 20% tax penalty applies to most nonqualified withdrawals.

There are three exceptions to the 20% penalty rule:

- 1) The withdrawal is made after the HSA account holder has reached age 65.
- 2) The HSA account holder becomes disabled as defined in Internal Revenue Code Section 72(m)(7).
- 3) The HSA account holder dies. The HSA ceases to be an HSA and becomes taxable as income to the beneficiary (separate rules apply to a surviving spouse – see below).

### Special Situations

The transfer of HSA funds as part of a divorce settlement is not treated as a nonqualified distribution. Amounts transferred are treated as HSA funds of the recipient former spouse.

If the account holder dies and the surviving spouse was the designated beneficiary, the surviving spouse inherits the HSA (tax-free) and may continue to withdraw funds for qualified expenses on a tax-free basis.

Note: State and local tax treatment of distributions may be different from federal tax treatment.



## COMMON PROBLEMS & SOLUTIONS

### Eligibility

Plan design elements such as deductibles used in the high deductible plan or an incompatible FSA or HRA design can create an HSA eligibility problem. Six potential problems along with possible solutions are outlined below.

#### *Deductible Problems*

##### **Short Plan Year**

**Situation:** An employer with a calendar year PPO plan wants to replace the plan with an HDHP and HSA combination on July 1, 2016. The employer wants to continue to operate on a calendar year basis with the new HDHP/HSA plan to be in place for only 6 months. The employer wants to use lower deductibles for the rest of 2016 - \$650 self-only and \$1,300 family since the coverage is only for 6 months (\$650 and \$1,300 are ½ of the statutory minimums of \$1,300 and \$2,600).

**Problem:** The minimum annual deductibles for an HDHP to be qualified are \$1,300 for self-only coverage and \$2,600 for family coverage (any coverage other than self-only) in 2016. The minimum annual deductibles may not be prorated for plan years shorter than 12 months.

**Possible Solution:** Implement the \$1,300/\$2,600 deductibles for the July 1 to December 31, 2016 time period, but permit carry forward deductible credits from January through June 2016. (Note: The current and carry forward period may not exceed 12 months.)

##### **Embedded Deductibles**

**Situation:** The medical plan has the minimum \$1,300/\$2,600 deductibles, but the family deductible is \$1,300 per person with \$2,600 overall maximum rather than a single \$2,600 minimum deductible for the family as a unit. One employee has coverage for himself, his wife and two children. The plan will begin paying benefits (other than preventive care) as soon as any family member has expenses that exceed \$1,300 even if no other family member has medical expenses.

**Problem:** If the medical plan pays any benefits before the family as a unit satisfies the minimum deductible (\$2,600 in 2016), the medical plan does not satisfy the requirements to be a qualified High Deductible Health Plan (HDHP) and the employee is not HSA eligible.

**Possible Solution #1:** Eliminate the embedded deductible so that the medical plan will not pay benefits until the family has satisfied the \$2,600 deductible.

**Possible Solution #2:** Keep the embedded deductible, but increase the single deductible to the level of the minimum family deductible. Possible designs could include: \$2,600/\$5,000, \$2,600/\$4,000, or \$2,600/\$2,600.

## **Carry Over Deductibles**

**Situation:** The employer has deductibles of \$1,300/\$2,600 but the medical plan includes a 3-month deductible carry over provision (i.e., amounts credited during October, November and December 2015 count toward the 2016 deductible).

**Problem:** The minimum annual deductibles for an HDHP to be qualified are \$1,300 for single coverage and \$2,600. With a carry-over provision the deductible accumulation period is 15 months rather than 12 months.

**Possible Solution #1:** Eliminate the 3-month carry over provision if the plan wants to use the minimum deductibles of \$1,300 and \$2,600.

**Possible Solution #2:** Increase the deductible amounts to adjust for the longer time frame to accumulate expenses. For a plan with a 3-month carry over the minimum deductibles would be \$1,625 ( $\$1,300/12 \times 15$ ) and \$3,250 ( $\$2,600/12 \times 15$ ).

## ***Incompatible Health Plans***

### **General Purpose Health FSA**

**Situation:** The employer has a general purpose health FSA – i.e., the FSA will reimburse any deductible health care expense (medical, dental, drug, vision) for the employee, spouse and any tax dependent of the employee.

**Problem:** Any employee who is enrolled in the FSA is automatically HSA ineligible since she is entitled to reimbursement of medical claims below the minimum deductible. Note: This problem cannot be solved by having the employee agree to not submit claims or to submit claims only for expenses such as dental and vision.

**Possible Solution #1:** Redesign the FSA so that reimbursement is limited to dental, vision, preventive care expenses and/or medical expenses that exceed the HDHP deductible. Medical expenses below the HDHP deductible would be ineligible.

**Possible Solution #2:** Add a second HSA-compatible FSA so that employees who want to contribute to an HSA can enroll in the HSA-compatible FSA. Employees who do not want to be HSA eligible will still be able to receive reimbursement for non-preventive medical claims below the HDHP minimum deductible amount.

### **Health FSA with a Grace Period**

**Situation:** The employer has a general purpose calendar year health FSA with a 2 ½ month grace period. The employer wants to implement an HDHP/HSA plan on January 1, 2016.

**Problem:** Employees who are enrolled in a calendar year FSA during 2015 will not be HSA eligible until April 1, 2016. Since HSA eligible is determined on the 1st day of each month and they would still be in the grace period until mid-March, their first eligible month would be April 2016. One exception is available – if the employee has a \$0 balance in the health FSA account on 12/31/2015, she will be HSA eligible beginning on January 1, 2016. However, the \$0 balance is on a cash basis – the maximum amount in the FSA must have been paid out by December 31. Claims that have been incurred, but not submitted or submitted but not yet paid are not counted as paid claims.

**Possible Solution #1:** Eliminate the health FSA grace period. Note: This may not be feasible for the current year plan since employees may have made elections assuming that the grace period would be available.

**Possible Solution #2:** Amend the health FSA to limit eligible expenses during the grace period to expenses that can be paid by an HSA-compatible FSA – i.e., dental, vision, preventive care and medical expenses above the minimum deductible. The amendment must apply to all FSA participants for the entire grace period.

**Additional Suggestion:** Communicate the HSA eligibility rules mid-year to ensure that employees understand that they will not be HSA eligible if their FSA account has not be exhausted on a cash basis before December 31.

### **Incompatible Health Reimbursement Arrangement**

**Situation:** Employer currently has a calendar year HDHP with a Health Reimbursement Arrangement (“HRA”) that reimburses eligible medical, dental, drug and vision expenses. The employer wants to change to an HDHP with an HSA on January 1, 2016. Most of the employees have a balance in their HRA accounts.

**Problem:** Any employee who has a balance in his HRA on January 1, 2016 will be HSA ineligible since he would be covered by a health plan that is not a qualified HDHP. This employee would not be HSA eligible until his HRA balance is \$0.

**Possible Solution #1:** Amend the HRA plan to limit benefits to: (1) dental; (2) vision; (3) preventive care; and/or (4) medical expenses that exceed the minimum statutory deductible (e.g., \$1,300 single and \$2,600 family for 2016).

**Possible Solution #2:** Amend the HRA plan to permit employees to suspend reimbursements for the calendar year (1/1/2016 -12/31/2016). This election must be made before 1/1/2016 (before coverage begins). Expenses incurred while the HRA is suspended may not be reimbursed during the suspension period or a later period. There is an exception for permitted coverage or benefits such as dental, vision and preventive care.

**Possible Solution #3:** Amend the HRA to make it a retirement HRA – i.e., no expenses would be reimbursable from the HRA until after the employee retires. Only expenses incurred after the employee retires would be eligible.

## **Contributions**

The amount an individual may contribute to an HSA is generally 1/12 of the annual maximum amount multiplied by the number of months of HSA eligibility. However, changes in the individual’s status during the year, the age of the individual (i.e., over age 54) and a special rule for some part-year eligible individuals makes the calculation more complex. In addition, any employer contributions made must either be made through a cafeteria plan subject to cafeteria plan nondiscrimination rules or outside a cafeteria subject to very stringent comparability rules. Finally, under certain circumstances there is a special rule that makes it possible to accelerate contributions for employees who have high medical expenses early in the calendar year.

### ***Employee Mistakes***

#### **Employee Not HSA Eligible**

**Situation:** The employee selects family coverage under the employer’s HDHP/HSA and elects to contribute \$300 per month to the HSA under the employer’s cafeteria plan. His wife waives medical coverage under her employer’s health plan, but enrolls in her employer’s general purpose FSA.

**Problem:** Mid-year, after the employee has contributed \$1,800 to his HSA account, he finds out that he is not HSA eligible because his wife enrolled in a general purpose FSA. Since the employee has not been HSA eligible at any time during the year, he can't contribute any amount to an HSA.

**Solution:** The employee will need to withdraw all of the funds and close the HSA. He will also need to cancel his \$300 HSA election under the cafeteria plan. (Note: No other cafeteria plan changes may be made.) The employer will need to include the \$1,800 already deducted on the employee's Form W-2 as taxable income. The employee will need to report any interest earned on the \$1,800 while in the account since it will be taxable.

#### **Employee Contributions Exceed Maximum (Loses Eligibility)**

**Situation:** In January an employee selects husband & wife coverage under the employer's HDHP/HSA and contributes \$550 per month to the HSA under the employer's cafeteria plan. In June the employee is divorced. In late October the employee remembers that he needs to change his HSA election.

**Problem:** The employee has already contributed more than the maximum amount to his HSA even if he remains HSA eligible for November and December 2016. He has contributed \$5,500 ( $\$550 \times 10$  months). The maximum he can contribute for the full calendar year is 6 months at the family level ( $\$6,750/12 \times 6 = \$3,375$ ) plus 6 months at the self-only level ( $\$3,350/12 \times 6 = \$1,675$ ) or \$5,050.

**Solution:** The employee will need to withdraw the excess funds (\$450 plus earnings) and cancel his HSA contributions for November and December. The employer will need to report \$450 as taxable income on the employee's Form W-2. The employee will be responsible for reporting any interest earned on the \$450.

#### **Employee Contributions Exceed Maximum (Part Year Eligible)**

**Situation:** An employee is hired in June 2016 and enrolls in single coverage in the employer's HDHP/HSA plan effective July 1, 2016. The employee elects to make pre-tax HSA contributions of \$400 per month for the rest of 2016. At open enrollment in December, the employee changes to a \$500 deductible PPO for January 1, 2017.

**Problem:** While an employee who is HSA eligible on December 1, 2016 may make the full contribution for 2016 (\$3,350 for single HDHP coverage), the employee must remain HSA eligible during a "testing period" which in this case would be all of 2017. If the employee does not remain HSA eligible during this testing period, his contribution is limited based on the number of months he was HSA eligible during 2016 – 6 months for this employee. This employee's maximum HSA contribution for 2016 would be \$1,675 (1/2 of the full \$3,350 maximum). By the end of 2016, he has contributed \$2,400.

**Solution:** The employee will need to withdraw the excess funds (\$775 plus earnings) before his April 17, 2017 tax filing deadline. If he does not withdraw the excess funds including earnings, he will be subject to an excise tax on excess funds and earnings. *Note: If the employee loses HSA eligibility at a later point in the testing period such as July 2016, he will still need to withdraw the excess funds and earnings but will not be able to avoid paying an excise tax.*

### ***Employer Mistakes***

#### **Employer Mistakenly Contributes to an Employee's HSA**

**Situation:** The employer makes a mistake in entering payroll information in January and inadvertently contributes \$300 to an HSA for both John K. Smith and John R. Smith. John K. Smith was never HSA eligible.

**Problem:** Contributions made by an employer to an HSA are nonforfeitable with two limited exceptions – contributions made to the account of an individual that was never HSA eligible and contributions that exceed the statutory maximum.

**Possible Solution:** The employer may ask the HSA custodian to return the \$300 since the employee was not HSA eligible. If the HSA custodian is unwilling to return the funds, the employer may request reimbursement from the employee. If neither the custodian nor the employee repays the funds, the \$300 must be included as taxable income on the employee's Form W-2. John K. Smith will need to withdraw the funds including earnings before his tax filing deadline in order to avoid an excise tax on those funds. He will also need to report the earnings from the account since they will be taxable. (Note: In order to avoid this type of situation, employers may want to have employees sign an agreement to repay mistaken contributions as part of the enrollment process.)

### **Employer Mistakenly Contributes too much to an Employee's HSA**

**Situation:** An employer contributes \$100 per month to HSAs of employees with self-only coverage and \$200 per month to HSAs of employees with family coverage. The employer mistakenly contributes \$200 per month the HSA of an employee with self-only coverage in January, February and March. The mistake is discovered in mid-March

**Problem:** The employer has contributed \$600 to the employee's HSA rather than the correct amount of \$300. The two limited exceptions for mistaken contributions – not HSA eligible or over the statutory maximum – do not apply in this case. Contributions to an employee's HSA are nonforfeitable. The two exceptions – not HSA eligible or over the statutory limit – do not apply. The employer may not request repayment of the incorrect amount from the HSA trustee/custodian.

**Possible Solution #1:** Suspend contributions to the employee's HSA in April, May and June so that the amount deposited will be correct at the end of June. Resume the normal contribution in July. This may not be feasible if the mistake is discovered near the end of the year.

**Possible Solution #2:** The employer may request repayment of the \$300 from the employee. If the employee does not repay the funds, the \$300 must be included as income on the employee's Form W-2.

Note: In order to avoid this type of situation, employers may want to have employees sign an agreement to repay mistaken contributions as part of the enrollment process.

### **Employer Makes Wellness Contributions (Outside the Cafeteria Plan)\***

**Situation:** Separate from the cafeteria plan, an employer's wellness program pays employees a \$300 "bonus" if they complete a health risk assessment questionnaire during the plan year. The \$300 is deposited into the employee's HSA account. The employer has 100 employees with an HSA. 90 employees complete the HRA and receive the \$300 contribution. 10 employees who do not complete the HRA do not receive any employer contribution to their HSA account.

**Problem:** Since the contribution is made outside the employer's cafeteria plan, the comparability rule applies. The employer must make a contribution equal to either the same dollar amount or the same percentage of the deductible for each comparable participating employee who is HSA eligible. The comparability rule permits variations based only on the following categories: single/family, full-time/part-time, highly compensated/non-highly compensated, or current/former employee. Since 10 employees did not receive an employer contribution, the comparability rule has not been satisfied.

**Possible Solution #1:** Make contributions through the employer's cafeteria plan rather than outside the cafeteria plan. The comparability rule does not apply to contributions made inside the employer's cafeteria plan (cafeteria nondiscrimination rules would apply.)

**Possible Solution #2:** The employer could make a \$300 contribution to the HSA of the remaining 10 employees.

*\*The same problem arises if the employer makes matching HSA contributions outside a cafeteria plan.*



## **Employer Contributes More for Employees Earning Less than \$75,000 (Outside the Cafeteria Plan)**

**Situation:** The employer makes a \$1,000 contribution for employees who earn less than \$75,000 and a \$500 contribution for employees who make \$75,000 or more. The employer's contributions are made outside the employer's cafeteria plan.

**Problem:** The employer is permitted to make higher (but not lower) contributions for non-highly compensated employees. However, the employer must make comparable contributions within the two categories based on the Internal Revenue Code definition of highly compensated – which is compensation in excess of \$120,000 for 2015.

**Possible Solution #1:** Make contributions through the employer's cafeteria plan, rather than outside the cafeteria plan. The comparability rule does not apply to contributions made outside the employer's cafeteria plan (cafeteria nondiscrimination rules would apply).

**Possible Solution #2:** Make an additional \$500 contribution for all employees who earn \$75,000 to \$115,000.

## **Accelerating Contributions**

### ***Employer Wants to Accelerate the Employer's HSA Contributions***

**Situation:** The employer implements a new HDHP/HSA plan with a \$1,500 single deductible on January 1. The employer contributes \$100 per month to the employee's HSA during the year. Employees are permitted to add to their accounts via salary reduction. An employee with single coverage has an HSA salary reduction amount of \$100 per month. The employee has surgery in March and wants to use his HSA to cover the \$1,100 bill.

**Problem:** The balance in the employee's account on April 1 will be only \$600 (\$100 employee + \$100 employer for 3 months). The employer wants to accelerate its contribution by paying an additional \$300 in April so that the employee can pay the entire \$1,100 expense from his HSA (\$600 balance + \$100 regular employer + \$100 regular employee + \$300 accelerated employer contribution = \$1,100).

**Possible Solution:** The employer may accelerate its contributions to his HSA as long as: (1) the employee has incurred qualified medical expenses that exceed the employee's current HSA balance, (2) accelerated employer contributions are available to all participating employees throughout the plan year; and (3) accelerated contributions must be provided to all participating employees on the same terms. However, any contributions made to an employee's HSA account are nonforfeitable. If the employee receives the accelerated contribution at the beginning of April and leaves at the end of April, the employer may not recoup the additional contribution from the HSA. The employer may request repayment from the employee outside the HSA and plan, but may not be successful.

### ***Employer Wants to "Accelerate" Salary Reduction HSA Contributions***

**Situation:** The employer implements a new HDHP/HSA plan with a \$1,500 single deductible on January 1. The employer does not contribute to the employee's HSA during the year. Employees are permitted to contribute to their accounts via salary reduction. An employee with self-only coverage has an HSA salary reduction amount of \$200 per month. The employee has surgery in March and wants to use his HSA to cover the \$1,100 bill.

**Problem:** The balance in the employee's account on April 1 will be only \$600. The employee will not have sufficient funds to pay the entire surgery bill from his HSA account.

**Possible Solution:** The employer may contribute \$600 to the employee's account in April ("accelerate" the employee's salary reduction contributions) as long as: (1) the employee has incurred qualified medical expenses that

exceed the employee's current HSA balance, (2) accelerated contributions are available to all participating employees throughout the plan year; (3) accelerated contributions must be provided to all participating employees on the same terms; and (4) the employee must repay the accelerated amount by the end of the plan year. (Note: If the employee leaves before the end of the year, the employer may not be able to recover the entire amount. The employer may not recover from the HSA. While the employer can request repayment from the employee outside the plan, as a practical matter the employer may not be successful.)

## Distributions

Distributions from an HSA are handled by the HSA trustee or custodian. Generally, the trustee/custodian should be able to respond to the employee's questions about distributions. However, while employers are not involved in the distribution process, they may want to respond to questions from employees.

### *Non-Qualified Distribution*

#### **Employee Receives Reimbursement for a Non-Tax Dependent**

**Situation:** An employee has family coverage under the employer's HDHP/HSA plan. The employee reimburses \$500 of medical expenses for his domestic partner from his HSA account. The domestic partner is not the employee's federal tax dependent.

**Problem:** The domestic partner's expenses would not be qualified since the domestic partner is not the employee's tax dependent. The distribution is taxable and subject to the 20% penalty as a non-qualified expense.

**Possible Solution:** There is no solution to this problem. HSA's are governed by federal law and definitions. One thing employers can do to help is communicate the rules to employees. Under federal law, the individual can only take qualified distributions for himself, his spouse; and his tax dependents. The distribution will be taxable and subject to the 20% penalty.

#### **Employee Receives Refund of Overpayment from a Healthcare Provider**

**Situation:** An individual receives services from a healthcare provider and pays his \$300 coinsurance from funds in his HSA. The provider later determines that he billed an incorrect amount and that the correct coinsurance is \$250. The provider sends the individual a check refunding the \$50 overcharge.

**Problem:** The individual has received a \$300 reimbursement from the HSA account when his qualified expense was only \$250. The additional \$50 is reimbursement of a non-qualified expense.

**Possible Solution:** Using the IRS guidance on permitted corrections based on a "mistake of fact", it appears that the individual should be able to redeposit the \$50 refund into his HSA account, but he would need to do so before his April 15 tax filing deadline. If instead he cashes the check and keeps the cash rather than re-depositing the money into his HSA, the \$50 would be a non-qualified distribution subject to tax and the 20% penalty.

### *Qualified Distribution*

#### **Employee who is Currently HSA Ineligible Uses HSA Funds for Medical Expenses**

**Situation:** An employee was covered under an HDHP/HSA plan in 2013 and 2014. She currently has a \$3,000 balance in her HSA account. In 2015, she enrolls in a \$500 deductible PPO plan and is not HSA eligible. The employee incurs medical expenses in 2015 and uses \$300 from her HSA to cover medical expenses not payable by the PPO plan.



**Problem:** There is no problem. The distribution from the HSA is a qualified expense. She does not need to be HSA eligible when she uses funds from the HSA, only when she puts money into the HSA. (She may not, however, double-dip by paying expenses from her HSA that are paid by her HDHP plan.)

### **Employee Receives Reimbursement for a Dependent Covered under an Incompatible Health Plan**

**Situation:** An employee has self-only coverage under an HDHP. His wife has self-only coverage through her employer under a \$ 500 deductible PPO. The employee wants to use funds in his HSA to pay \$400 of his spouse's medical expenses that are not reimbursable by her PPO plan.

**Problem:** There is no problem. The employee's wife is not eligible to set up or contribute to an HSA account. However, the spouse's expenses are qualified expenses under the employee's HSA. The only restriction is that the expense cannot be reimbursed by insurance (i.e., can't be paid twice). Note: the result would be the same if the employee had family coverage as long the \$400 expense was not covered under with medical plan.

## **Other Situations**

A few problems involve situations where an HSA account is not established on a timely basis or the trustee/custodian selected by an employee is not approved.

### ***Non-Approved HSA Trustee***

**Situation:** An employer has a calendar year HDHP and in 2015 contributed \$50 each month to the HSA of any employee who enrolled in its HDHP. The employer did not select the HSA trustee/custodian. Employees must set up their own HSA accounts and provide information about the account so that the employer can transfer its \$50 contribution each month. An employee set up an HSA account and gave the employer the necessary account information. The employer transferred funds to employees' accounts every month in 2015.

**Problem:** In January 2016, the employee discovers that the "trustee" he chose is not an approved HSA trustee/custodian (banks and insurance companies can be HSA account trustees, other entities must be approved by the IRS) and employee notifies HR. The employer has already deposited \$600 into the account. Since the trustee is not approved, this account is not an HSA.

**Possible Solution:** The \$600 deposited into the account by the employer must be included as taxable income on the Form W-2 for 2015. The employee will need to remove the \$600 and any earnings from the account prior to April 15, 2016 in order to avoid an excise tax. The \$600 and earnings are both taxable income. Note: The employee may still be able to establish an HSA for 2015 as long as he does so before his tax filing deadline (April 15, 2016). He may then deposit funds into the account and take a deduction (above the line) on his federal tax return. He would not be able to reimburse any expenses incurred before the HSA account is established.

### **Employee has Not Established an HSA Account**

**Situation:** An employer has a calendar year HDHP and in 2015 contributes \$50 each month to the HSA of any employee who enrolls in its HDHP. The employer does not select the HSA trustee/custodian. Employees must set up their own HSA accounts and provide information about the account so that the employer can transfer its \$50 contribution each month.

**Problem:** The employer transfers funds to employees' accounts every month, but is unable to make a contribution for two employees since they have not set up an HSA account by December 31, 2015.

**Possible Solution:** The employer is required to notify employees of the requirement to set up an HSA in order to receive the employer's contribution. If the employee does not set up the account and notify the employer by the end

of February (February 29, 2016 for the 2015 calendar year), the employer is not required to make its contribution. If the employee does set up the account and provide the necessary account information to the employer by February 29, 2016, the employer must make the contribution by April 15, 2016. (Note: If the employee sets up the account in January 2016, he/she may receive the 2015 contribution but will not be able to receive reimbursement for any 2015 expenses. Employers may want to include this information in communications to employees.)

## APPENDIX

- I. Statutory Limits – HDHP & Contributions Preventive Care Services – Safe Harbor
- II. Preventive Care Services – Safe Harbor
- III. Partners and 2% Owners in Subchapter S Corporations
- IV. ERISA

### Statutory Limits – HDHP and HSA Contributions

	2015	2016
<b>HDHP Deductibles</b>		
Single	\$1,300	\$1,300
Family	\$2,600	\$2,600
<b>HDHP Out of Pocket Maximums</b>		
Single	\$6,450	\$6,550
Family	\$12,900	\$13,100
<b>Maximum Annual Contributions</b>		
Single	\$3,350	\$3,350
Family	\$6,650	\$6,750
Catch-up (55 & older)*	\$1,000	\$1,000

\*Amount set by law, not indexed.

### Preventive Care Services – Safe Harbor

Note: In addition to any of the preventive care safe harbor services listed below, an HSA-compatible HDHP may also cover PPACA-required preventive services. This means that employees who participate in a non-grandfathered HDHP that complies with PPACA's requirement to cover specified preventive services (without cost-sharing) will **not** be ineligible to contribute to HSAs. See IRS Notice 2013-57 for details.

- Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, (e.g., annual physicals).
- Routine prenatal and well-child care.
- Child and adult immunizations.
- Tobacco cessation programs.
- Obesity weight-loss programs

- Screening services (*see below*)
- Preventive drugs and medicines

### ***Preventive Care Screening Services***

#### **Cancer**

- Breast Cancer (e.g., Mammogram)
- Cervical Cancer (e.g., Pap Smear)
- Colorectal Cancer
- Prostate Cancer (e.g., PSA Test)
- Skin Cancer
- Oral Cancer
- Ovarian Cancer
- Testicular Cancer
- Thyroid Cancer

#### **Heart and Vascular Diseases**

- Abdominal Aortic Aneurysm
- Carotid Artery Stenosis
- Coronary Heart Disease
- Hemoglobinopathies
- Hypertension
- Lipid Disorders

#### **Infectious Diseases**

- Bacteriuria
- Chlamydial Infection
- Gonorrhea
- Hepatitis B Virus Infection
- Hepatitis C
- Human Immunodeficiency Virus (“HIV”) Infection
- Syphilis
- Tuberculosis Infection

## **Mental Health Conditions and Substance Abuse**

- Dementia
- Depression
- Drug Abuse
- Problem Drinking
- Suicide Risk
- Family Violence

## **Metabolic, Nutritional, and Endocrine Conditions**

- Anemia, Iron Deficiency
- Dental and Periodontal Disease
- Diabetes Mellitus
- Obesity in Adults
- Thyroid Disease

## **Musculoskeletal Disorders**

- Osteoporosis

## **Obstetric and Gynecologic Conditions**

- Bacterial Vaginosis in Pregnancy
- Gestational Diabetes Mellitus
- Home Uterine Activity Monitoring
- Neural Tube Defects
- Preeclampsia
- Rh Incompatibility
- Rubella
- Ultrasonography in Pregnancy

## **Pediatric Conditions**

- Child Developmental Delay
- Congenital Hypothyroidism
- Lead Levels in Childhood and Pregnancy

- Phenylketonuria
- Scoliosis, Adolescent Idiopathic

### **Vision and Hearing Disorders**

- Glaucoma
- Hearing Impairment in Older Adults
- Newborn Hearing

## **Partners & 2% Shareholders (Subchapter S Corp)**

### ***Partners***

The tax treatment of partnership contributions to a partner's HSA will depend on how the partnership treats the contribution. The general rules are outlined below.

Note: These are the general rules. The partner (or partnership) should consult his/her/their tax advisor for the rules that apply to his/her/their situation.

### **Guaranteed Payments under IRC 707(c)**

If payments to a partner's HSA are treated by the partnership as guaranteed payments under Internal Revenue Code 707(c), then the payments are:

- Deductible by the partnership;
- Includable in the partner's gross income [not excludable under IRC Section 106(d), because they are treated as a distributive share of the partnership income ];
- Reported as guaranteed payments on Schedule K-1;
- Includable in the partner's net earnings from self-employment; and
- Deductible on the partner's personal federal income tax return.

### **Partnership Distribution under IRC 731**

If payments to a partner's HSA are treated by the partnership as distributions under Internal Revenue Code Section 731, then the payments are:

- Not deductible by the partnership and do not affect the distributive shares of partnership income and deductions;
- Not included in the partner's earnings from self-employment;
- Reportable as distributions of money on Schedule K-1; and
- Deductible on the partner's personal federal income tax return.

	<u><b>HSA Contribution</b></u>
Alan (General Partner)	\$300
Brian (Limited Partner)	\$300
Carl (Limited Partner)*	\$300
Don (Employee)	\$200
Ellen (Employee)	\$200
*Paid \$300 annually for services to partnership (guaranteed payment) the \$300 HSA contribution is in lieu of paying the guaranteed payment directly [Section 707(c)].	
<b>HSA Contributions for Alan and Brian are treated as a cash distribution (Section 731).</b>	

## ***2% Shareholders – Subchapter S Corporation***

For certain purposes, Section 1372 of the Internal Revenue Code treats Subchapter S corporations as partnerships and 2% shareholders of a Subchapter S corporation as partners. In general, Subchapter S corporation payments to the HSA of a 2% shareholder are treated as guaranteed payments under Internal Revenue Code Section 707(c). **Note: These are the general rules. The 2% shareholder (or Subchapter S Corporation) should consult his/her/their tax advisor for the rules that apply to his/her/their situation.**

In general, amounts treated as guaranteed payments under Internal Revenue Code 707(c), are:

- Deductible by the Subchapter S corporation;
- Includable in the 2% shareholder's gross income\* [not excludable under IRC Section 106(d)]; and
- Deductible on the 2% shareholder's personal federal income tax return.

\*Included for FIT, but not FICA.

Additional information can be found in IRS Notice 2005-8.

## **ERISA**

Most HSAs will not be ERISA plans even if the HSA receives employer funds or permits employee pre-tax contributions. The Department of Labor ("DOL") provided a safe harbor for HSAs that receive either (or both) employer contributions or salary reduction amounts. These plans will not be considered ERISA plans if the employer does not:

- 1) Limit the employee's ability to move funds to another HSA (except for restrictions imposed by the Internal Revenue Code);
- 2) Impose conditions on how the employee may (or may not) use the money in his HSA account (except for restrictions imposed by the Internal Revenue Code);
- 3) Make or influence investment decisions with respect to funds contributed to the HSA;
- 4) Represent the HSA as an employee welfare benefit plan established or maintained by the employer; or
- 5) Receive any payment or compensation in connection with the HSA.