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June 18, 2004

CC:DOM:CORP:R (Revenue Ruling 2004-45)
Internal Revenue Service
Room 5226
PO Box 7604
Ben Franklin Station
Washington, DC 20004

Re: Health Savings Accounts Guidance (Rev. Rul. 2004-45)

Dear Sir/Madam:

On behalf of the Employers Council on Flexible Compensation ("ECFC"), we express our sincere gratitude for the all the recent Health Savings Accounts ("HSAs") guidance. We also appreciate the receptiveness of the Treasury Department and Internal Revenue Service to input from the employer plan sponsor community. We are excited by the demonstrated promise that consumer-centric health care has shown for helping resolve the current health care cost crisis (e.g., through health reimbursement arrangements or "HRAs"). We believe that HSAs also will help to alleviate this crisis. However, we are concerned that several issues may serve to impede the growth of HSAs, and literal application of some of the existing historical regulatory requirements may discourage employers from offering this valuable benefit to their employees.

In response to the request for further comment in Rev. Rul. 2004-45 we would like to express several concerns that employers have relating to HSAs. In Section A below, we provide suggestions regarding the employer role in HSAs that has emerged as plan sponsors look to implement a new health benefit. ECFC will be publishing these comments in its upcoming ECFC Flex Reporter. We would be pleased to discuss this issue with you further.

Sincerely,

Bonnie B. Whyte, CFCI, CAE

The Employers Council on Flexible Compensation (ECFC) is a non-profit trade association committed to the study and promotion of defined contribution plans, 401(k) plans, cafeteria plans, and other elective compensation plans. Approximately 14-18 million Americans receive flexible benefits from the more than 2800 members of ECFC. Members of ECFC are plan sponsors, corporations, governments, unions, universities, hospitals, and clinics as well as leading actuarial, administration, consulting, insurance and accounting firms that design and administer flexible benefit plans. Founded in 1981 by Fortune 500 corporations, Council members have great experience in designing and administering compensation and benefit programs that offer flexibility for employers and employees.

Employer-Restricted HSAs: This Could Be the Start of Something Really Big

By Mark Wincek, Esq., CFCI, Kilpatrick Stockton LLP

Probably no other decision in the upcoming Treasury and Internal Revenue Service HSA guidance will have a greater impact on the long-term potential of HSAs than that regarding whether, and to what extent, employers may place restrictions on the use of HSA funds. If HSAs are able to attract significant employer contributions, this will unquestionably and markedly enhance their appeal to employees. However, the prospects for significant employer contributions to HSAs appear to depend on whether contributing employers can rely on employees dedicating an adequate portion of those contributions to the payment of essential medical expenses. A recurring theme sounded by employer after employer is that their willingness to make HSA contributions will turn on whether they are given a sufficient voice in the use of HSA funds that are contributed by the employer. Quite simply, many employers wish to ensure these funds are primarily available for necessary medical expenses. The question, therefore, is will this be allowed?

Early on, the issue of whether employers could restrict the use of HSA funds did not make the lists of items that Treasury and IRS planned to address in the next tranche of HSA guidance, which is scheduled to be issued near or just after the end of June. More recently, however, Treasury and IRS have seriously considered including the issue on the final list, which reflects that Treasury and IRS have heard this is a priority issue for a significant number of employers. In addition, there have been discussions of the issue between Treasury and Capitol Hill, and reportedly Hill sources involved with the development of the HSA concept have expressed interest in the issue. Thus, it appears Treasury and IRS would like to address the question and, if it does not make it into the next tranche of guidance, it is a prime candidate for the additional round of guidance that has been informally discussed. Indeed, many employers would urge that the need to address this question would justify, by itself, another round of HSA guidance. But once again, the key question becomes will employers like the ultimate answer?

Harmonizing Employer Restrictions on HSAs with the HSA Legal Structure

To answer this question, it is necessary to consider the kinds of restrictions that employers want, and to explore the legal pressure points that Treasury and IRS will consider in deciding whether to permit these restrictions.

As suggested above, many employers want at least the funds they contribute to be restricted to medical expenses. As a minimum, this means only making these funds available for medical expenses that qualify under Code section 213, but many employers would go further, *i.e.*, they would restrict their HSA contributed funds just to those medical expenses that they deem sufficiently important. For example, this might include only those expenses that are eligible under the high deductible health plan (HDHP) that accompanies the HSA, or they might supplement this with a list of other medical expenses that are deemed deserving of priority, but probably not all over-the-counter drugs and certainly not non-medical expenses. This would be the first employer decision – what expenses to allow.

The second decision would be what amounts in the HSA would be restricted to these expenses. As suggested above, for most employers the answer would be some or all of the amounts derived from employer contributions. The principles that allow restrictions of employer funds could extend to employee contributed funds, but employers are unlikely to apply substantial restrictions to funds contributed by employees. For one thing, such restrictions would be hard to justify to employees, and they would have a negative impact on

employees' willingness to make contributions (and thus a negative impact on the success of the employer's HSA program).

The third employer decision would be how long the restriction of these HSA funds would continue. Currently, this involves a level of plan design detail that is beyond what most employers have thought through, but it goes to the heart of the legal issues under the HSA rules. As discussed below, it appears possible to navigate these legal issues with a design that should permit a long enough period of restriction to encourage employer contributions.

With these likely employer preferences in mind, it is possible to review the legal pressure points that arise and to consider whether these legal issues should prevent Treasury and IRS from authorizing employer-restricted HSAs.

- The Prohibition on Forfeitures of HSA Funds: Code section 223(d)(1)(E) provides that the interest of an individual in his or her HSA is "nonforfeitable." This rule applies to all amounts in an HSA, no matter their source, and thus it applies equally to both employer and employee money. Therefore, to comply with this provision, the HSA restrictions that limit HSA funds to being used only for specified medical expenses cannot apply forever. If they did, unusually healthy employees with HSAs would not be able to use all of their HSA balances for eligible medical expenses, and this could effectively accomplish a forfeiture of the unused balances, *i.e.*, they never could be utilized. But when do the restrictions have to be lifted to avoid a forfeiture issue? Is it sufficient if the restrictions are lifted at age 65 (or death, if earlier)? By analogy to the qualified retirement plan area that should be sufficient. For example, the rules for qualified plans permit participant distributions to be delayed until age 65, and this is not a violation of another qualified plan requirement, *i.e.*, the requirement for plan contributions to be nonforfeitable much earlier. Being nonforfeitable and being available for current distribution are simply different principles. Thus, an extended period of HSA restrictions should be permissible, but employers may find that much less significant restriction periods are sufficient to achieve the right balance of paternalism and employee access to HSA funds. For example, some have discussed lifting the restrictions to the extent the balance of the HSA exceeds the high deductible amount under the HDHP or with respect to amounts that were contributed in the prior year. What seems clear is that employers should be able to have significant latitude without creating a forfeiture issue.
- Control of the HSA and Rollovers: An HSA is in many respects similar to an IRA. Just like an IRA, an HSA is an individual account that the employee typically controls. Thus, if the employee on whose behalf the HSA or IRA has been established wants to move the funds in the account from one trustee to another, there are rollover rules to facilitate this. In the case of an employer-restricted HSA, however, it may be a practical necessity for the funds to stay with the trustee selected by the employer. For example, this may be the best way to ensure that the restrictions are enforced. Thus, an employer may ask employees to enter into an irrevocable agreement to leave the funds that are subject to restriction with the trustee selected by the employer for the duration of the restriction period. Is this impermissibly denying the employee control over the HSA or improperly negating the rollover right? It would seem not. The employee is voluntarily agreeing to these restrictions. In effect, the employee is choosing to forego certain opportunities that could be available under the HSA rules. However, no one would say that the tax status of an employee's HSA is endangered because the employee decides never to take advantage of the opportunity to rollover an HSA balance. Why should it be a problem because the employee voluntarily makes this decision at the outset? In addition, the analogy to qualified retirement plans again indicates that there should be no problem. Qualified plans have rollover rights, but an employee cannot take advantage of them until there is a plan distribution. As noted above, qualified plan distributions may be delayed until age 65, and this does not amount to an impermissible denial of rollover rights. Similarly, an HSA design that defers the opportunity to use rollover rights should not be an impermissible denial of those rights.

- Conditioning Contributions on the Employees' Accepting Restrictions: A natural way to build-in incentives for employees to agree to HSA restrictions would be for the employer to say that its contributions to the HSA are conditioned on employees agreeing to the restrictions. However, this raises a question of whether the employer is making comparable contributions available to all comparable participating employees, as required by Code section 4980G. If the contribution offered is otherwise comparable, the short answer would be that any employee can receive the contribution by agreeing to the restrictions, and so a comparable contribution is definitely *available* to all comparable participating employees. However, Treasury and IRS are wrestling with whether "available" should mean, in the case of HSAs, that the employer actually has to deliver a comparable contribution to all comparable participating employees. This question arises primarily in connection with employers' interest in making matching contributions to HSAs, and it triggers a Treasury and IRS concern that higher paid employees may get too much of the match. Thus, even though a match can easily make available the same contribution to everyone, that may not be enough. If that is how Treasury and IRS come out on the match issue, it likely would bar employers from directly linking their HSA contributions to the employees' acceptance of restrictions. In that case, however, the employer could strike a different bargain, *i.e.*, if you want to elect the HDHP/HSA option, you must agree to restrictions on the HSA; it is part of the package. Presumably this bargain is sufficiently removed from the availability of the contribution that it should not cause a problem. All those covered by an HDHP combination will receive a comparable employer contribution, which should be enough.
- Prohibitions on Pledges and Prohibited Transactions: Another area where HSAs resemble IRAs is the application to HSAs of the IRA rules against pledging an account as security for a loan, and against so-called "prohibited transactions." If an employee agrees to make his or her HSA subject to restrictions on using the HSA funds, is that a prohibited pledge? The clear answer appears to be "no." Although a pledge, on the one hand, and the employer/employee agreement restricting the HSA, on the other, are both contractual arrangements, the Code only penalizes pledges that secure loans. Here, the restriction agreement does not involve security for a loan. In turn, the prohibited transaction rules penalize certain specified transactions, *e.g.*, a sale, lease or loan between an HSA and a disqualified person, as well as a transfer between a plan and a disqualified person of the HSA's income or assets. However, none of these prohibitions are implicated by the restriction agreement between the employee and the employer. The restriction agreement does not result in a sale, lease, loan or transfer transaction involving HSA assets or income; rather, all of the HSA's assets and income remain in the HSA at all times. The agreement operates around and outside the HSA. It affects the employee's use of HSA funds, but it does not amount to a transaction with those funds. Therefore, the anti-pledge and prohibited transaction rules should not be a problem.

Conclusion and Other Implications (*i.e.*, ERISA)

In sum, it appears quite possible to design a set of restrictions on the use of HSA funds that avoid forfeiture issues, as well as problems under the other legal pressure points reviewed above. Certainly, an employer that obtains employees' agreement to restrictions on the use of HSA funds and on the ability of the employees to move those funds to a different trustee should assume that employees' HSAs will not qualify for the safe harbor exemption from ERISA coverage that the Department of Labor promulgated in Field Assistance Bulletin 2004-1. DOL representatives have indicated informally that such an employer (if subject to ERISA) would have created an ERISA welfare benefit plan. That may discourage some employers, but the practical truth is that employers know how to deal with ERISA. It seems clear that many employers will gladly accept that outcome. More importantly, all should have the right to make that choice. From the standpoint of Treasury and IRS, it is a non-issue, but what should be critical to Treasury and IRS is that permitting employer restrictions will result in more employer contributions to HSAs, more employees opting for HSAs and, ultimately, a terrific boost for the concept of consumer-directed health care. Something big indeed.