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Older Workers and Retirees: Avoiding HSA Pitfalls

Employers sponsoring HDHP/HSA programs for older workers need to be aware of the potential complications caused by Medicare Part A entitlement while those offering HDHP/HSA programs for retirees need to be concerned about the HSA comparability rules. Failure to address these issues can result in participant aggravation and potential excise taxes.

Background

In recent years, an increasing number of employers have adopted high-deductible health plans (HDHPs) coupled with health savings accounts (HSAs), frequently as their only health benefit offering. The HDHP/HSA trend is likely to continue, and perhaps even accelerate, during the Trump administration.

HSAs are tax-exempt savings vehicles funded by individual or employer contributions that may be used to pay for qualified medical expenses. Individuals can contribute to an HSA through deductible after-tax contributions or, if permitted, by pretax contributions made through an employer's cafeteria plan. Although not required to, employers may also contribute separately to an employee's HSA. If employees are permitted to contribute to their HSAs on a pretax basis, both the pretax and employer contributions are subject to the Section 125 discrimination rules. If employees cannot make pretax contributions, the employer contributions are subject to separate "comparability" requirements.

The maximum amount that can be contributed to an HSA for a calendar year (employer and employee contributions combined) is set by law – for 2017, the maximums are $3,400 for individuals with single HDHP coverage and $6,750 for individuals with family HDHP coverage. These amounts are increased by $1,000 for individuals age 55 and older. (See our May 2, 2016 *For Your Information*.) The applicable annual maximums are prorated to reflect the number of months during the year that the HSA account holder was an "eligible individual." For example, the maximum annual contribution limits for an eligible individual age 55 or older who became ineligible as of May 1, 2017 (i.e., was an eligible individual for only 4/12 of the year) would be $1,467 and $2,583, respectively.

While HDHP/HSA arrangements work well for most employees, employers need to be aware of some potential pitfalls when they are offered to older workers or retirees. These are discussed below.

Medicare and HSA Eligibility

Only "eligible individuals" may make HSA contributions or have employer HSA contributions made on their behalf. To be an eligible individual, an individual must be enrolled in an HDHP and cannot have other coverage that provides medical benefits prior to satisfaction of the statutory minimum HDHP deductible (in 2017, $1,300 for individual and $2,600 for family coverage). Because it would pay medical benefits before an individual meets the HDHP deductible, Medicare is disqualifying coverage.

When is someone eligible for premium-free Medicare Part A?

Generally, individuals are eligible for premium-free Medicare Part A if they or their spouses paid Medicare taxes while working.

Individuals become eligible for Medicare on the basis of age on the first day of the month in which they turn age 65. *Eligibility* for Medicare does not affect an individual's status as an eligible individual – for example, an employee enrolled in an HDHP who has reached age 65 may still contribute to an HSA and receive employer HSA contributions. However, a Medicare-eligible employee who becomes *"entitled*" to Medicare (i.e., has Medicare coverage in effect) loses HSA eligibility on the first day of the month in which his or her entitlement begins. This can pose problems for employees and employers because employees may not realize that they have become Medicare-entitled and/or know when that entitlement began. They may also not realize that entitlement to Medicare Part A affects HSA eligibility.

Entitlement to Medicare Part A

An individual becomes entitled to Medicare Part A by either

- Application for Social Security retirement benefits (automatic)
- Separate application for Medicare

In both cases, entitlement to Medicare Part A will be retroactive to the first day of the month in which the individual attains age 65 (or, if the individual applied more than six months after attaining age 65, to the first day of the month that is six months prior to the month of the application).

Many employees apply for Social Security retirement (SSR) benefits or Railroad Retirement Board (RRB) benefits when they reach age 65, even if they continue to be actively employed. Applying for these benefits automatically enrolls them in premium-free Medicare Part A, if they are otherwise eligible. Medicare Part A coverage is generally retroactive – an otherwise eligible individual who applies for SSR or RRB benefits within six months of attaining age 65, will become "entitled to Medicare" (i.e., Medicare Part A coverage will begin) on the first day of the month in which he or she attained age 65.

Elimination of retroactivity problem?

Bills recently introduced in the **House** and **Senate** would effectively eliminate the retroactivity problem by providing a prorated annual HSA contribution limit for the taxable year in which an individual first becomes entitled to Medicare. The proration would be based on the number of months during the year in which the individual was not Medicare-entitled. For example, under current law, the annual HSA contribution limit for someone who turned age 65 on March 9 and became Medicare-entitled on September 1 would be 2/12 of the applicable limit. Under the proposed legislation, the individual's annual contribution limit would 8/12 of the applicable limit.

An individual is treated as having attained age 65 on the day immediately preceding his or her 65th birthday. For example, an individual who was born on June 1, 1952 would attain age 65 on May 31, 2017 and Medicare Part A coverage would begin on May 1, 2017 if the individual applies for retirement benefits within six months after attaining age 65. If an individual applies for retirement benefits at a later date (i.e., more than six months after attaining age 65), Medicare Part A coverage will begin retroactively on the first day of the month that is six months prior to the date the application was filed.

Individuals who want to postpone the start of their SSR or RRB benefits to a later date (either because they are still working or have retired but want to maximize the amount of their monthly benefits) may file a separate application for Medicare Part A coverage. They will become "entitled to" Medicare Part A subject to the same retroactive coverage rules outlined above.

Waiver of Medicare Part A. Under *Hall v. Sebelius*, individuals receiving monthly Social Security or RRB benefits cannot waive Medicare Part A. The only way they can regain HSA eligibility is to withdraw their application for monthly retirement benefits and repay any benefits (both retirement and Medicare Part A) they had received to date. Only one request to withdraw an application is permitted and such request must be filed within 12 months of the determination that an individual was eligible for retirement benefits. Although legislation has been proposed that would permit otherwise eligible individuals enrolled in Medicare Part A to contribute to HSAs, no law adopting that change has been passed.

Correcting Excess Contributions

Because employees (or former employees) may not be aware that they are entitled to Medicare Part A and/or that their Medicare Part A entitlement is retroactive, they may establish HSAs when they are not eligible to do so. Also, because of the proration rule, they (and their employer) may make contributions to their HSAs in excess of their annual contribution limits if they become entitled to Medicare Part A during the year. They could be subject to a 6 percent excise tax on the amount of these "excess contributions" unless action is taken to distribute the excess in a timely manner.

If employee was not eligible to establish HSA

Employer HSA contributions (both employer and employee pretax) are generally nonforfeitable. However, the nonforfeitability rule does not apply when an HSA is established by an ineligible individual – in that case, the IRS in effect treats the HSA as never having existed. An employer may request that the account trustee or custodian return amounts contributed during the current taxable year. Contributions made by an employee on a pretax basis would be paid to the employee as wages and included in the employee's income as if the contributions hadn't been made. There would be no tax consequences to the employee with respect to the other contributions returned to the employer.

> **Comment**. The account trustee or custodian is not legally required to return the employer contributions to the employer. However, if the employer has selected the account trustee or custodian for the HSAs, they could be contractually obligated to do so.

If the employer does not recover the amounts by the end of the taxable year, it must report them as additional wages on the employee's Form W-2 for the year during which the employer made the contributions. If the employer does not learn until after the end of the taxable year that the employee had not been eligible to establish an HSA, the employer would have to issue a corrected Form W-2 for the prior year.

If employee became ineligible during the year

This “exception” to the nonforfeitability rule only applies when the individual was ineligible to establish an HSA at the time it was set up. If the individual was HSA-eligible at the time, the HSA was established but subsequently lost eligibility (e.g., the HSA was established before the individual become Medicare entitled), contributions cannot be returned to the employer. To avoid a 6 percent excise tax on any excess contributions, the individual must withdraw the excess contributions by the due date, including extensions, of his or her tax return for the year in which such excess contribution were made as well as any income earned on the withdrawn contributions. Both the excess contributions and the earnings must be reported as additional income on the individual’s tax return. If the individual fails to take this curative distribution, the excess contributions will be subject to the 6 percent excise tax for as long as they remain in the HSA.

Examples

These various issues are illustrated below. In each case, the employee’s monthly pretax contribution to his or her HSA was $200 and the employer’s monthly contribution was $50. Because the employees are all over age 55, their annual HSA contribution limit for 2017 is $4,400 for self-only coverage ($3,400 limit plus $1,000 “catch-up” contribution).

What if…?

If an employer contributes to an employee's HSA in the mistaken, but reasonable, belief that the employee is an HSA-eligible individual, the employer should not have to take corrective action later with respect to FICA, FUTA or Railroad Retirement Tax Act taxes if it subsequently discovers that the individual was not eligible for HSA contributions.

Example 1. In 2016, Lou was enrolled in Company A’s PPO plan. During 2017 open enrollment, Lou enrolls for self-only coverage under Company A’s HDHP/HSA plan with coverage to be effective January 1, 2017. Lou turned age 65 on December 22, 2016 and applied for Social Security retirement benefits on his birth date.

In September, 2017, Company A learns that Lou had become entitled to Medicare Part A on December 1, 2016 and that as a result, he was not an eligible individual at any time during 2017. At the time it learns about Lou’s ineligibility, Lou had contributed $1,600 to the HSA while Company A had contributed $400

In this situation, because Lou was not HSA-eligible on the date he established the HSA, Company A can request the HSA custodian to return all of Lou’s pretax contributions and its own contributions. If the amounts are returned by the end of the year, Lou would receive the $1,600 as wages that would be reported on his 2017 W-2 and the $400 returned to Company A would have no tax consequence to Lou.

If the contributions were not returned to Company A by the end of the year, Company A would report the full $2,000 ($1,600 + $400) as additional wages on Lou’s 2017 W-2.

Example 2. Sue enrolls for self-only coverage under Company A’s HDHP for 2017 and establishes an HSA. Sue turns age 65 on May 23, 2017 but does not apply for Social Security retirement benefits at that time. Sue retires on September 30, 2017 and applies for Medicare Parts A and B.

Because Sue applied for Medicare Part A coverage within six months of attaining age 65, her Part A coverage became effective (i.e., she became "entitled to Medicare") as of May 1, 2017. This means that that Sue was not an eligible individual for HSA contributions for May 2017 and subsequent months. Because of the proration rule, the maximum amount that could be contributed to Sue's HSA for 2017 was $1,467 ($4,400 times 4/12). However, her combined Company A and pretax contributions through September 2017 totaled $2,250, resulting in excess contributions of $783.

Useful Resources

Employees with questions about their HSA contributions should be referred to IRS Publication 969 or told to consult their tax advisor. Employers may want to include a statement about IRS Publication 969 and the recommendation regarding consulting a tax advisor in plan communications.

Since Sue's HSA was established when she was HSA-eligible, Company A cannot recoup the contributions. To avoid the 6 percent excise tax, Sue will have to take a taxable distribution of the $783 excess contributions plus any earnings attributable to those contributions by the last day for filing her 2017 tax return, including extensions.

Example 3. Mary, who is enrolled for self-only coverage in Company A's HDHP/HSA plan for 2017, attains age 65 on February 9, 2017 but does not apply for Social Security retirement benefits at that time, nor does she apply for Medicare. Mary retires from Company A effective January 1, 2018 and immediately applies for Social Security retirement benefits.

Because Medicare Part A coverage is retroactive for up to six months from the month in which the application for Social Security Retirement benefits is made (if the applicant is otherwise eligible), Mary became entitled to Medicare Part A effective July 1, 2017. This means that although Mary had been an eligible individual at the time the contributions were made for the months of July through December, 2017, her status changed and as a result, her annual contribution maximum for 2017 was reduced to $2,200 ($4,400 times 6/12). Since $3,000 was contributed to her HSA for 2017, Mary has excess contributions of $800.

Because Mary's HSA was established when she was HSA-eligible, Company A cannot recoup the contributions. To avoid the 6 percent excise tax, Mary generally would have to take a taxable distribution of the $800 excess contribution plus any earnings attributable to those contributions by the last day for filing her 2017 tax return, including extensions. However, if Mary had already filed her 2017 tax return, she will have six months following the due date for filing her 2017 return, including any extension, in which to take the taxable distribution and file an amended return.

Retiree HSAs and the Comparability Rules

An employer may want to offer HDHP coverage to its pre-age 65 retirees and continue to fund their HSAs. However, because retirees typically would not be able to contribute to their HSAs through the employer's cafeteria plan, the employer contributions must satisfy HSA comparability rules. These rules generally require an employer to make comparable contributions (i.e., contributions in the same amount or same percentage of the applicable deductible) to HSAs of all comparable participating employees (HSA eligible employees in the same category of employee and enrolled in the

What are comparable contributions?

"Comparable contributions" are HSA contributions that, for each month in a calendar year, are the same amount for each HSA-eligible individual with the same category of HDHP coverage on the first day of that month. Contributions are also considered comparable if they are the same percentage of the applicable HDHP deductible.

same category of HDHP coverage). Employers that fail to do this will be subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs during the calendar year.

"Comparable participating employees" are HSA-eligible employees who are: (1) in the same category of employee, and (2) enrolled in the same category of HDHP coverage. For this purpose, there are three categories of employees:

- Current full-time employees (those who usually work at least 30 hours per week)
- Current part-time employees (those who work fewer than 30 hours per week)
- Former employees (other than former employees who have continued their HDHP coverage under COBRA)

Categories of HDHP coverage are limited to "self-only" coverage and the following types of "other than self-only" (family) coverage – self plus one, self plus two, and self plus three or more.

Identification of comparable participating employees is generally made on a controlled group basis. Collectively bargained employees are not comparable participating employees with respect to other employees if health benefits were the subject of bargaining. In addition, in determining whether contributions to non-highly compensated employees are comparable, highly compensated employees are excluded, which means that employers can contribute more to the HSAs of non-HCEs. The converse is not true; non-HCEs are not excluded in determining whether contributions to HCEs satisfy comparability rules. Status as a highly compensated employee for this purpose is the same as it is for retirement plan discrimination testing.

Who is an HCE?

For 2017, an employee is an HCE if he or she:

- Was a more-than-5 percent owner of the employer at any time during the current or preceding year
- Had compensation in excess of $120,000 in 2016 and, if elected by the employer, was also in the "top-paid group" (generally the top 20 percent in compensation)

Retirees fall into the "former employee" category discussed above. This means that the employer may make different contributions to the HSAs of retirees than it does for current full-time or part-time employees. However, the contributions to the retirees' HSAs must be comparable to those made to the HSAs of other individuals in the "former employee" group. Therefore, unless the exclusions for collectively bargained or highly compensated employees apply, the employer's contribution to retiree HSAs must be the same for all retirees enrolled in the same category of HDHP coverage and cannot vary based on age or service, geographical location, etc. It must also be the same for any other former employee (other than a former employee on COBRA) enrolled in the same category of HDHP coverage who is receiving employer HSA contributions.

> **Comment**. This could be a problem for employers that agree to make HSA contributions to a former employee pursuant to a severance agreement. They may fail the comparability requirements if they do not contribute the same amount to the HSAs of retirees enrolled in the same coverage category.

Example 1. Company A has two divisions – Division N and Division O – and offers HDHP coverage to pre-age 65 retirees in both divisions. Company A contributes to the HSAs of Division N retirees enrolled in HDHP coverage but does not contribute to the HSAs of Division O retirees enrolled in HDHP coverage. Company A does not satisfy the comparability rules.

Example 2. XYZ Company offers retiree HDHP coverage to former salaried and hourly employees who satisfy certain age and service requirements. It contributes to the HSAs of the salaried retirees but not to the HSAs of hourly retirees. XYZ Company does not satisfy the comparability rules.

Example 3. QRS Company offers retiree HDHP coverage but does not contribute to retirees' HSAs. As part of its severance agreements with executives leaving the company, QRS Company agrees to continue their HDHP coverage for 24 months at active employee rates (so there is no COBRA-triggering loss of coverage) and to continue to contribute to their HSAs. Because both the former executives and retirees fall within the category of former employees (other than former employees who have continued their HDHP coverage under COBRA), QRS Company would be required to make comparable contributions to the HSAs of retirees to satisfy the comparability rules.

Example 4. NOP Company offers HDHP coverage to both active employees and retirees. Active employees can contribute to their HSAs through pretax contributions; retirees cannot. NOP Company contributes $50 a month to the HSAs of all HDHP participants who complete a health risk assessment; HDHP participants who do not complete the health risk assessment do not receive the contribution. Because active employees can make pretax contributions to their HSA, NOP Company does not violate the comparability rules even though it does not contribute the same amount to all active employees enrolled in the same category of HDHP coverage. However, NOP Company does violate the comparability rules for retirees since they do not contribute to HSAs on a pretax basis.

An employer that fails to satisfy the comparability rules for a calendar year is subject to a 35 percent excise tax on all HSA contributions it makes for that year, not just those contributions that were non-comparable. Employers liable for the 35% excise tax generally must report their liability on IRS Form 8928 (Return of Certain Excise Taxes under Chapter 43 of the Internal Revenue Code) and pay the tax by the April 15 following the calendar year in which they made non-comparable contributions. The IRS may waive part or all of the excise tax to the extent that payment of the tax would be excessive relative to the failure involved. However, this only applies to failures due to reasonable cause and not willful neglect.

What about HRAs?

Employer contributions to a health reimbursement arrangement (HRA) are not subject to the HSA comparability rules but are subject to separate nondiscrimination rules. However, employers that want to provide financial assistance through health reimbursement arrangements will need to proceed carefully to avoid potentially unwelcome consequences (for example, the loss of eligibility for Marketplace subsidies for non-Medicare-eligible retirees). See our **August 24, 2015** *For Your Information.*

In Closing

Employers sponsoring HDHP/HSA programs need to be aware of these potential complications. In the case of older workers, employers should expand employee communications to inform them about how their HSA eligibility may be affected by Medicare entitlement. Employers providing HDHP coverage to retirees should keep the HSA comparability rules in mind when determining whether to make HSA contributions.

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