THE Pension Digest

October 2006
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Collin W. Fritz and Associates, Inc.,
"The Pension Specialists"

2006 IRS Instructions for Forms 1099-R and 5498 — What's New?

Except for a few exceptions as discussed below, there are few changes in the 2006 Instructions. Surprisingly, there is no discussion concerning the special tax rules available for distributions and contributions for those affected by the hurricanes. There is also no special reason code for qualified hurricane distributions, nor any mention of the fact that the additional 10% tax is not owing on such distributions.

Form 5498

One main difference here is language discussing extended contribution dates for U.S. Armed Forces in designated combat zones. Combat pay is now considered to be compensation for IRA contribution purposes. The applicable IRS language discussing the rules as enacted by the Heroes Earned Retirement Opportunities Act of 2006 is reproduced below.

"Special reporting for U.S. Armed Forces in designated combat zones. A participant who is serving in or in support of the Armed Forces in a designated combat zone or qualified hazardous duty area has an additional period after the normal contribution due date of April 15 to make IRA contributions for a prior year. The period is the time the participant was in the designated zone or area plus at least 180 days. The participant must designate the IRA contribution for a prior year to claim it as a deduction on the income tax return.

Under section 219(f) as amended by the HERO Act, P.L. 109-227, combat zone compensation that is excluded from gross income under section 112 is treated

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IRS Issues 2007 COLAs

IRS Announces Cost-of-Living Adjustments for 2007
The IRS in News Release No. IR-2006-162 Released its 2007 Adjustments as Follows:

	2005	2006	2007
Taxable Wage Base — OASDI Only	$90,000	$94,200	$97,500
SEP and Qualified Plan Maximum Compensation Cap – 401(a)(17) & 404(e)	$210,000	$220,000	$225,000
Elective (Salary) Deferral Limit – 401(k) & SAR-SEP	$14,000	$15,000	$15,500
Elective Deferral Catch-up Limit	$4,000	$5,000	$5,000
SIMPLE Deferral Limit – 408(p)(2)(A)	$10,000	$10,000	$10,500
SIMPLE Catch-up Limit	$2,000	$2,500	$2,500
Highly-Compensated Employees (Compensation as Indexed)	$95,000	$100,000	$100,000
Defined Benefit Limit – Section 415(b)(1)(A)	$170,000	$175,000	$180,000
Defined Contribution Limit – Section 415(c)(1)(A)	$42,000	$44,000	$45,000
SEP Minimum Compensation Threshold – 408(k)(2)(c)	$450	$450	$500
Key Employee Top Heavy — 41(i)(ii)(a)(i)	$135,000	$140,000	$145,000

2006 IRS Instructions for Forms 1099-R and 5498,
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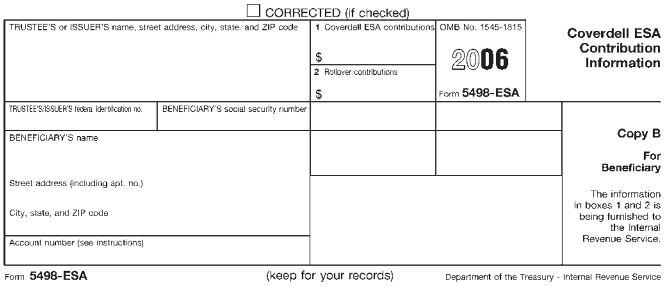
☐ CORRECTED (if checked)

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code

1 Coverdell ESA contributions $

2 Rollover contributions $

OMB No. 1545-1815

2006

Form 5498-ESA

Coverdell ESA Contribution Information

TRUSTEE'S/ISSUER'S federal identification no.

BENEFICIARY'S social security number

BENEFICIARY'S name

Street address (including apt. no.)

City, state, and ZIP code

Account number (see instructions)

Copy B For Beneficiary

The information in boxes 1 and 2 is being furnished to the Internal Revenue Service.

Form 5498-ESA (keep for your records) Department of the Treasury - Internal Revenue Service

as includible compensation for purposes of determining IRA contributions.

If a qualifying combat zone participant makes a contribution to an IRA after April 15th and designates the contribution for a prior year, you must report the type of contribution (box 7) and the amount on Form 5498. Report the amount either for (1) the year for which the contribution was made or (2) a subsequent year.

1. If you report the contribution for the year it is made, no special reporting is required. Include the contribution in box 1 of an original Form 5498 or of a corrected Form 5498 if an original was previously filed.

2. If you report the contribution on Form 5498 in a subsequent year, you must include the year for which the contribution was made, the amount of the contribution, and one of the following indicators:

a. Use "AF" (Allied Force) for the Kosovo area.

b. Use "JE" (Joint Endeavor) for the Persian Gulf area.

c. Use "EF" (Enduring Freedom) for Afghanistan, Uzbekistan, Kyrgyzstan, Pakistan, Tajikistan, and Jordan.

d. Use "IF" (Iraqi Freedom) for the Arabian Peninsula Areas (the Persian Gulf, the Red Sea, the Gulf of Oman, the portion of the Arabian Sea that lies north of 10 degrees north latitude and west of 68 degrees east longitude, the Gulf of Aden, and the total land areas of Iraq, Kuwait, Saudi Arabia, Oman, Bahrain, Qatar, and the United Arab Emirates and the airspace above such locations).

See Pub. 3, Armed Forces' Tax Guide, for a list of the locations within the designated combat zones and qualified hazardous duty areas.

Example. For a $4,000 IRA contribution designated for Enduring Freedom for the tax year 2005, enter "EF 2005 4000" in the blank box next to box 10.

Additional Rules for 2004 and 2005. Under the HERO Act, participants whose compensation was excluded from gross income under section 112 for 2004 or 2005, may make an IRA contribution for either or both years, treating the excluded compensation as includible compensation for purposes of section 219, provided the contribution is made no later than May 28, 2009. File a separate Form 5498 for these contributions for each year for which the contributions are made, following the special reporting rules above."

A "caution" has been added, stating, "You are required to file Form 5498 even if RMDs or other payments have started."

There is a note under the 5498 "Instructions to Participant" that, even though it is not new for 2006, you will want to be aware. It states: "**Note:** If you postponed making a contribution to your IRA or certain retirement plans, in the box to the left of box 10, there should be a reason code, the year to which the contribution was credited, and the amount of the contribution."

CWF Comments: Remember, the normal maximum contribution amount for 2006 is $4,000 for those younger than age 50, and $5,000 for those age 50 and older. Also, because April 15, 2007, is a Sunday, IRA contributions may generally be made through April 16, 2007.

As you may or may not be aware, the IRS 1099-R distributions codes apply to IRAs, pension plans, and insurance annuities. CWF believes it would be helpful and less confusing to IRA custodians as well as accountholders, if the IRS would identify which code(s) applies to which type of distribution.

Form 1099-R

New language has also been added under the explanations for using Distribution Code 1 — Early distribution, no known exception. It states "Use Code 1 only if the employee/taxpayer has not reached age 59½ and you do not know if any of the exceptions under

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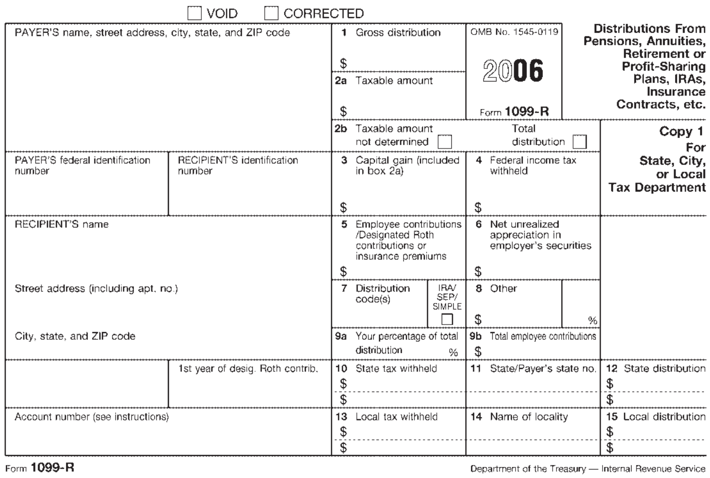
2006 IRS Instructions for Forms 1099-R and 5498, Continued from page 2



VOID CORRECTED

PAYER'S name, street address, city, state, and ZIP code

1 Gross distribution $

OMB No. 1545-0119

2006

Form 1099-R

Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

2a Taxable amount $

2b Taxable amount not determined ☐ Total distribution ☐

Copy 1 For State, City, or Local Tax Department

PAYER'S federal identification number

RECIPIENT'S identification number

3 Capital gain (included in box 2a) $

4 Federal income tax withheld $

RECIPIENT'S name

5 Employee contributions /Designated Roth contributions or insurance premiums $

6 Net unrealized appreciation in employer's securities $

Street address (including apt. no.)

7 Distribution code(s) IRA/ SEP/ SIMPLE ☐

8 Other $ %

City, state, and ZIP code

9a Your percentage of total distribution %

9b Total employee contributions $

1st year of desig. Roth contrib.

10 State tax withheld $ $

11 State/Payer's state no.

12 State distribution $ $

Account number (see instructions)

13 Local tax withheld $ $

14 Name of locality

15 Local distribution $ $

Form 1099-R

Department of the Treasury — Internal Revenue Service

Distribution Code 2, 3, or 4 apply. Use Code 1 even if the distribution is made for .... a qualified reservist distribution under section 72(t)(2)(B), (D), (E), (F) or (G)."

By instructing that an individual use Code 1 for a qualified reservist distribution, the IRS is then leaving it up to the individual to explain on their 1040 tax return why the distribution should not be taxable.

Excess Contribution Code Change: "For distribution of excess contributions without earnings after the due date of an individual's return under section 408(d)(5), leave box 2a blank, and check the 'Taxable amount not determined' checkbox in box 2b. Use Code 1 or 7 in box 7, depending on the age of the participant." The 2005 instructions directed that box 2a should be filled in with "0" in this situation.

Designated Roth Accounts. Because of the new Roth 401(k) deferral option, the IRS has much discussion concerning the reporting of contributions and distributions. This, however, is a qualified plan topic, not an IRA topic. Roth 401(k) deferrals are made under a 401(k) plan, not an IRA plan. However, Roth 401(k) deferrals are allowed to be rolled over to a normal Roth IRA, which would then mean the Roth IRA rules would apply. Roth 401(k) deferrals are to be kept separate from the other funds in a 401(k) plan. The "Instructions for Recipient" are as follows:

"Basis in your account is reported in box 5, and the first year of the 5-year holding period is shown in the box to the left of box 10. A separate Form 1099-R is required to report a distribution to you from the designated Roth account. Generally, Code B will be shown in box 7." (Code B is a new code for distributions from a designated Roth account under a section 401(k) plan or a section 403(b) plan.)

The following discussion has been added to better explain to the accountholder the completion of boxes 1 and 2a.

"IRAs. For distributions from an IRA, SEP, or SIMPLE, generally the payer is not required to compute the taxable amount. Therefore, the amount in boxes 1 and 2a will be the same most of the time. See the Form 1040 or 1040A instructions to determine the taxable amount. If you are at least age 70½, you must take minimum distributions from your IRA (other than a Roth IRA). If you do not, you may be subject to a 50% excise tax on the amount that should have been distributed. See Pub. 590 for more information on IRAs.

Roth IRAs. For distributions from a Roth IRA, generally the payer is not required to compute the taxable amount. You must compute any taxable amount on Form 8606. An amount shown in box 2a may be taxable earnings on an excess contribution."

Qualified Plan Distribution Form — Employer Must Furnish

When a participant in an employer-sponsored qualified pension plan separates from the service of the employer, certain procedures must be followed. One important procedure mandated by law is that the employer must furnish such separating employee with a form which details the options the employee has for receiving a distribution from the pension plan.

The form is required to list these three options for distribution of a plan participant's vested balance:

1. Direct Rollover — Payment can be made directly to a traditional IRA that the separating participant has established, or to an eligible employer plan that will accept such funds and hold them for the individual's benefit,

2. Payment can made directly to the individual, or

3. A portion of the payment may be directly rolled over and the remainder can be paid to the individual.

The most common choice is number one, where the individual establishes an IRA and has the qualified

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Qualified Plan Distribution Form, Continued from page 3

plan funds directly rolled over into such IRA.

Besides providing the above information to the separating participant, the employer will also wish to provide an election form which the individual will complete and return to the employer. On this form, the individual will choose one of the three options and will include the address of where to send the check. If they have requested that their funds be rolled over to an IRA, the form should have a place to certify that the individual has established an IRA at a financial institution, and will have space to indicate the address of the financial institution to which the check is to be sent.

Because of the importance and tax consequences of a qualified plan distribution, and employer will want to provide a proper "paper trail," should a question ever arise concerning a distribution. Therefore, an employer will want to provide a form such as CWF's Form #857 election form and booklet. These items provide all the information a separating plan participant will need to make an informed decision as to how they will have their qualified plan funds paid out. ◆

Options for Nonspouse Roth IRA Beneficiary

As you are aware, a Roth IRA beneficiary has no rollover rights. Therefore, the two distribution options available for a Roth IRA beneficiary are the 5-year rule and the life-distribution rule. If the 5-year rule is not specifically elected, the life-distribution rule is deemed to be elected by default.

Under the 5-year rule, the funds in the Roth IRA must be totally distributed to the beneficiary by 12/31 of the year containing the fifth anniversary of the accountholder's death. Under the life-distribution rule, the beneficiary is allowed to have the funds distributed over his or her life expectancy.

Unless a Roth IRA beneficiary needs the money, it is best to leave the funds in a Roth IRA as long as possible, because the earnings grow tax free, and will be tax free when distributed. This is an excellent tax benefit of which you, as IRA custodian, will want to make Roth IRA beneficiaries aware.

Even if the 5-year Roth holding period had not been met when the decedent died, the beneficiary can normally still receive tax-free income, because of the ordering rule for Roth distributions. The first funds distributed from a Roth IRA are an individual's basis (contributions); next, conversion contributions (the oldest first); and lastly, earnings. Therefore, even if the five-year holding period has not been met by the accountholder when the beneficiary inherits the Roth IRA, because contributions are distributed first, by the time the beneficiary is distributed any earnings, the five-year period will, in most cases, have been met, meaning the earnings will not be taxable.

Because one of the exceptions to the 10% additional tax rule has been met, (death), the inheriting beneficiary does not have to be age 59½ to receive a "qualified" distribution, and, as explained above, even when earnings are distributed, they will not be subject to tax. The IRA custodian will code all inherited Roth IRA distributions as "death" distributions.

There may be the scenario where the Roth funds a beneficiary inherits are within a bank time deposit which has not yet matured. In such case, the financial institution will want to have its policy in place concerning whether or not it will waive the early withdrawal penalty in the case of the death of the accountholder, or whether it will not waive it, and subject the beneficiary to such penalty.

The example below shows the benefit of leaving funds in the inherited Roth IRA as long as possible.

Assume an individual with $15,500 in his Roth IRA, died in 2006, leaving his niece (age 50) as his sole beneficiary. If the niece were to use the 5-year rule, she will have to have this amount distributed to her by 12/31/11. Under this distribution option, she will maximize the benefits of compounding as well as tax-free earnings by leaving the dollars in the account until 12/31/11.

If she chooses the life-distribution rule, she will be able to extend distributions over her life expectancy (34.2 years). If interest is paid at 4%, and compounded annually, the account will earn $620 in interest in the first year, and she will only be required to withdraw $453.22. The second year, the earnings will be $601.87, and she will be required to withdraw $451.94. As you can see, by choosing the life-distribu-

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Options for Nonspouse Roth IRA Beneficiary, Continued from page 4

tion rule, at least for the first few years, the beneficiary is actually able to earn more in interest than she is required to withdraw. The savings would be even more dramatic, and this benefit would continue for more years, if the account earned a higher interest rate.

Summary. To maximize earnings in a Roth IRA, a beneficiary will wish to extend the payout period as long as possible. The best choice for a nonspouse beneficiary is the life-distribution rule. Even though this is the default rule, CWF recommends that an IRA custodian have the beneficiary complete and sign a distribution form where they specifically choose the life-distribution rule. If they desire to use the 5-year rule, they will have to indicate this via a distribution form, also. ◆

Inform Your Roth Customers — They Need to Tell Tax Preparer of Roth IRA Contributions

There is no requirement to inform the IRS when an individual makes a Roth IRA contribution; no governmental reporting is required, because no tax deduction is allowed for a contribution to a Roth IRA. A Roth IRA is funded with after-tax dollars.

An individual may not even think to inform his or her tax preparer that they have made a Roth IRA contribution during the year. When an individual determines his or her modified adjusted gross income for tax purposes at the end of the year, they may discover that their income is too high, and they were actually not eligible to contribute to a Roth IRA. Any Roth IRA contributions made during such year would therefore be impermissible, and would be deemed an excess contribution to the Roth IRA. An excess contribution is subject to a 6% excise tax for every year the excess remains in the account. However, an individual is allowed to correct an excess Roth IRA contribution without owing the 6% tax, if the excess contribution is removed, along with the applicable earnings, by October 15 of the year following the year the excess amount was contributed.

CWF believes it would be good customer service for Roth IRA custodians to suggest to all Roth IRA contributors that they inform their tax preparer of their Roth IRA contribution. The tax preparer can then determine whether or not the individual was eligible to make such contribution, and thus avoid the tax consequences of an impermissible (excess) Roth IRA contribution.

An easy way to keep customers informed of Roth IRA rules and regulations is by providing Roth IRA customers with CWF's Roth IRA lobby brochure. The brochure can help customers and their tax preparers determine an individual's eligibility to make a Roth IRA contribution. ◆

Retirement Tips for Individuals

The Service offers an individual the following tips to help him or her take responsibility for their retirement.

Set a Goal — "I think I can save $25 a paycheck." It's easy to procrastinate, so set up a "painless" payroll deduction for saving. It doesn't matter if the money goes into a 401(k) plan, an IRA, or into a plain, old-fashioned savings account, just start saving. You can start with a small amount and increase it whenever your circumstances allow—like when you get a raise, your car payments end or you get a bonus. Pay yourself now, you'll thank yourself later.

Open an IRA — IRAs are easy to get, easy to contribute to and easy to save with. Most Americans can set up an IRA—whether it's a traditional IRA or a Roth IRA—and save on taxes. Find out more about IRAs from your bank or financial institution or the resources below.

Learn About Your Employer's Retirement Plan — If you are covered under your employer's retirement plan, your employer is required to give you a plain language explanation of the plan called a "summary plan description." It describes your rights under the retirement plan. To get a summary plan description, ask the plan administrator or your employer.

Review Your Individual Benefit Statement — Your individual benefit statement shows your total plan benefits and the amount that is vested, or fully owned by you. To get an individual benefit statement, ask your plan administrator or employer.

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Retirement Tips for Individuals,
Continued from page 5

Sign Up for 401(k) Contributions — If you are covered under a 401(k) plan, you may have to designate the amount of money you want taken out of your salary and contributed to your 401(k) account by the end of the year. The 401(k) limit is $15,000 for 2006 ($20,000 if you are 50 or older in 2006) and $15,500/$20,500 for 2007.

Take Your Required Minimum Distributions — If you are 70½, you are generally required to receive a required minimum amount from your qualified retirement plan or IRA by year-end.

Review Your Social Security Statement—The Social Security Administration likely sends you a Social Security Statement each year about three months before your birthday. This statement is your personal record of earnings on which you have paid Social Security taxes and a summary of estimated benefits you and your family may receive as result of those earnings. These benefits include retirement benefits and protection in case you become disabled or die before retirement age. For more information and to request a Social Security Statement, go to www.ssa.gov.

Learn About Your Spouse's Retirement Plan—Many retirement plans provide benefits for spouses. For example, your spouse's plan may provide that you will receive an annuity unless you consent to distribution in another form. Before signing, read and understand any waiver or consent forms for your spouse's retirement plan distributions. ◆

First-Time Home Buyer Question

CWF received the following question concerning IRA funds and the first-time home buyer exception.

Situation: An IRA accountholder, age 55, withdrew $9,500 from his savings account. He gave this money to his son to use as a down payment on a principal residence. At that time, the accountholder was unaware of the IRA rule allowing the withdrawal of funds from his IRA for the first-time home purchase of a child. Because the son qualifies as a first-time home buyer (he has had no ownership in a principal residence for a period of two years) the accountholder now wishes to reimburse his savings account from his IRA, and claim the first-time home buyer exception as the reason for the withdrawal, thus avoiding the 10% additional tax normally owing on a premature withdrawal from an IRA. Is this permissible?

Under the first-time home buyer rules, an individual can withdraw up to $10,000 (lifetime limit) from their IRA to purchase, build, or rebuild a principal residence for themselves, their spouse, children, grandchildren, and any ancestor of themselves or their spouse, and avoid the 10% early withdrawal penalty. However, as with any distribution from a traditional IRA (other than nondeductible contributions), normal income tax will be owing on the distribution. The funds must be used within 120 days of the date of distribution, to pay "qualified" acquisition costs. These costs include the cost of buying, building or rebuilding a home, as well as any usual or reasonable settlement, financing, or other closing costs. In other words, the IRA distribution must be related only to the purchase of the property; the funds cannot be used for other expenses related to the individual's principal residence, such as maintenance, repairs, furnishings, or any other similar expense.

It certainly would have been permissible for the individual to withdraw the $9,500 from his IRA to pay the acquisition costs of his son's principal residence. Now, however, because the funds will be paid to the savings account and not to the seller of the property or the lender who is financing it, we at CWF do not believe this course of action is permitted. Even if the individual himself would have paid the savings account funds directly to the lender, reimbursement from the IRA still would not be permissible, as payment to a savings account is obviously not a "usual" part of the acquisition costs of the property. If the individual withdraws the amount from his IRA, he will be subject to normal income tax, plus the 10% early withdrawal penalty. ◆

–THANKSGIVING HOLIDAY—
CWF will be closed on Thanksgiving Day and the day after— November 23 & 24, 2006.

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Do Debit Cards & Checking Accounts Work With IRAs?

We have heard that some IRA custodians have given their IRA accountholders a debit card as a way to withdraw funds from an IRA. CWF does not believe the IRS has issued any written guidance saying that a debit card may be used with respect to a distribution from a traditional IRA or a Roth IRA. Our concern is this — the standard tax rule is that a distribution is considered to have occurred, for income tax purposes (including reporting purposes), if the funds are "available" to the accountholder. In the past, the IRS has seen the existence of a plan document provision requiring the IRA participant to request a distribution as meaning the funds were not immediately available for federal income tax purposes. Because of this "not immediately available" rule, we would be surprised if the IRS would agree to the use of debit cards for IRAs. Again, we are aware that some e-banks are issuing such debit cards with respect to IRAs, but we at CWF believe it is highly dangerous to do so, without some written authorization from the IRS saying that this is permissible. At this point, we do not believe the IRS has issued such authorization. The IRS may well argue that the entire IRA balance was available, and, therefore, taxable.

The IRA withholding rules also cause a problem for the use of a debit card. The withholding rules require the IRA custodian to furnish the withholding notice and election each and every time there is a nonperiodic distribution. I believe these withholding rules would need to be changed before the use of a debit card would work.

Conclusion. Until the IRS issues written guidance stating that a taxable event does not occur until a person actually writes a check or uses the debit card, we believe an IRA custodian should not make IRA funds available to its accountholders via a checking account or debit card. ◆

Right to Amend Provision

CWF received a call concerning what would need to be done to change a time deposit agreement for an HSA to an HSA checking account.

In order to make such a change, the time deposit agreement would have to expressly authorize that the agreement may be amended. Many agreements do have this provision, allowing a change to the agreement upon giving the customer 30 days' written notice. However, a special amendment would need to be written.

CWF's time deposit agreement does give an institution the right to amend a time deposit agreement by providing such adequate notice to the accountholder.

Assuming that amending the agreement is authorized, our understanding is that an HSA custodian will be required to furnish the customer the amended agreement and a truth-in-savings disclosure detailing the new terms.

If you find that your bank has NOT reserved the right to amend the time deposit agreement, you will have to convince the customer to sign a new agreement incorporating the checking account terms. The bank will need to sign the new agreement, also. You will need to add language to your vendor's normal agreement authorizing the transfer of the funds from the time deposit to the checking account because of this special situation.

Summary. It is best to have language in any agreement between a bank and an account owner (for any account, not just an HSA), stating that the terms of the account are allowed to be amended by the institution upon giving the account owner adequate written notice (usually 30 days). Failure to provide such a provision upon the opening of an account can result in the institution having to comply with the original terms of the account even when the institution decides a different policy would be better, and wishes to change such terms. ◆

Reporting Roth Distributions

As you are aware, there is no IRS reporting required when an individual makes a normal Roth IRA contribution. We assume this is because such contribution is made with after-tax dollars, and the IRS has already received the applicable taxes on the amount.

What, then, is required when funds are distributed from a Roth IRA? The Roth IRA custodian will prepare a 1099-R. The gross amount of the distribution will be entered in box 1 of the form. Box 2a (taxable amount) is generally left blank. The reason code 7 (normal distribution from a traditional IRA) is not to be used for a distribution from a Roth IRA. Code T is to be used for a Roth distribution when the custodian does not know if the 5-year holding period has been met, and an exception (attainment of age 59½, death, or disability) applies; Code Q is to be used for a "qualified" Roth distribution when the custodian knows that the 5-year holding period has been met and one of the above-listed exceptions applies. If neither Code T or Q applies, the custodian must use Code J — early distribution from a Roth IRA (i.e. a nonqualified distribution before age 59½, and no known exception applies).

For a non-taxable distribution from a traditional IRA, normally an individual must complete IRS Form 8606 to indicate why such distribution is not taxable. For a Roth IRA distribution, Form 8606 must only be completed if the Roth distribution is a nonqualified distribution (meaning earnings which were distributed may be taxable). Form 8606 has no place to indicate that a Roth distribution is qualified.

The only way the IRS is informed of a qualified Roth IRA distribution is on an individual's Form 1040 income tax return. On line 15a, the gross amount of the distribution is to be reported, and on line 15b, the taxable amount will be entered. In the case of a qualified Roth IRA distribution, the taxable amount (line 15b) will be "0." Therefore, if Code Q is used on an individual's Form 1099-R for a Roth distribution, Form 8606 need never be completed, as the distribution is qualified, and, therefore, not taxable.

An individual also does not need to complete Form 8606 if a distribution Code T is used, and the individual made a contribution (including a conversion) to a Roth IRA in 1999 or 2000. ◆

Employer HSA Contributions

In August of 2006, the IRS issued its final regulations with respect to contributions made by an employer to the HSAs of its employees. There were some "good" surprises found within these regulations. There are some results more favorable to the employer than one would have reasonably expected. These regulations apply to employer contributions to HSAs on or after January 1, 2007. Prior to 2007, an employer will be found to be in compliance with the HSA comparability rules as long as was compliance with the rules set forth in the proposed regulations as issued in August of 2005.

An employer is not required to make any contribution to the HSAs of its employees. However, if an employer chooses to make such contributions, then for any given calendar year, the employer must make certain nondiscriminatory *comparable contributions* to the HSAs of all *comparable participating employees.* An employer is subject to an excise tax equal to 35% of the employer's aggregate contributions for the given calendar year if comparable contributions have not been made. There are, however, some major exceptions to this requirement that an employer must make comparable contributions to the HSAs of all comparable participating employees.

The first major exception is that the employer may sponsor a cafeteria plan (section 125) which gives an employee the right to defer a portion of his or her wages to their HSA on a pre-tax basis. The HSA comparability rules do not apply to HSA contributions made pursuant to a Section 125, plan because Section 125 has its own set of nondiscrimination rules. In general, the nondiscrimination rules of Section 125 (as discussed later regarding eligibility, contributions, benefits and key employee concentration) are easier to meet than the HSA comparability rules. Section 125 plans are also called "cafeteria plans." To qualify for this exception, it is required that the written cafeteria plan agreement must give the employees eligible for the cafeteria plan the right to make pre-tax salary reduction (i.e. elective deferrals) contributions to their HSAs. The general rule of a section 125 plan is that the employee must have the right to receive cash or

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other taxable benefits in lieu of their HSA pre-tax contribution. However, there are some exceptions when the employer is permitted to make its contribution even though the employee does not have the right to receive cash or other taxable benefits as long as the employee may make his or her own elective deferrals.

The IRS has furnished a number of examples to illustrate the effect of these rules when the employer has a written cafeteria plan which permits employees to elect to make pre-tax salary reduction contributions to their HSAs. This is the critical rule. The employee must have the right to make elective deferral contributions to their own HSA on a pre-tax basis. If so, it will be possible for an employer to impose special conditions with respect to the contributions the employer will directly make to an employee's HSA. A determination will need to be made whether such contributions satisfy the nondiscrimination rules found in Code section 125. The HSA comparability rules do not apply. The section 125 rules rather than the HSA comparability rules will be applied to the following situations. First, as long as the eligible employees are permitted to make salary elective contributions to their HSA, an employer may make automatic employer contributions to those employees who are eligible for an HSA contribution even though such employees are not given the right to receive cash or other taxable benefits in lieu of the employer's contribution. Second, an employer is permitted to make a non-elective matching contribution (e.g. $400) to the HSA of each employee who makes a pre-tax HSA contribution. Third, an employer agrees to make a non-elective contribution (e.g. $600) to the HSAs of all employees who complete a health risk assessment and participate in the employer's good health program.

How is it determined that there have been comparable contributions?

The general HSA comparable contribution rule is -— there must be comparable contributions for comparable participating employees. However, this rule is to be applied on a per HDHP coverage category basis and on a per classification of employee basis. The simplest HDHP coverage situation is that there are only two HDHP categories — self-only coverage and family coverage. Each category is tested separately. The final regulation authorizes an HDHP with family coverage to be broken down into numerous sub-categories and each sub-category is tested by itself. For example, an HDHP with the following categories would allow each category to be tested separately:

1. Self-only;
2. Self plus one's spouse;
3. Self plus one dependent;
4. Self plus spouse plus one dependent; and
5. Self plus spouse plus two or more dependents

When the HDHP has more than one category that provides coverage for the same number of individuals, then all such categories must be aggregated and treated as a single category. For example, in the above situation, the category of "self-only and spouse" must be aggregated with "self plus one dependent," as both categories have two individuals.

Example of Plans With Comparable Contributions

1. The employer sponsors an HDHP which has self-only coverage and family coverage. The employer contributes $750 to the HSA of each employee with self-only coverage and $1,000 to the HSA of each employee with family coverage. Does the giving of this preference (a $250 larger contribution) to individuals with family coverage violate the HSA comparable rules? No.

There are two coverage categories and they are tested separately.

2. The employer sponsors an HDHP which has the following categories with the following contributions: (1) Self-Only — $500; (2) Self plus One — $750; (3) Self plus Two $900 and (4) Self plus three or more — $1,000. The HSA comparability rules are met even though the contribution amounts vary, as each category is tested separately.

What contributions must be considered in determining if there has been comparable contributions? What special rules must be applied in determining whether the comparability rules have been met?

The general rule is that any "employer" contributions to an employee's HSA must satisfy the comparability rules.

Rollover contributions to an HSA are not made by the employer. Consequently, rollover contributions are

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not subject to the comparability rules. It does not matter if the funds were distributed from another HSA or an Archer MSA.

After-tax employee contributions are also not tested. These contributions are not contributions under Code section 106(d), and, consequently, are not to be tested under the comparability rules. Such after-tax employee contributions will be made pursuant to a payroll deduction HSA program wherein the employee instructs the employer to forward his or her after-tax amounts to their HSA.

Contributions on behalf of individuals who are partners are not tested (subject to the comparability rules), because such contributions are not contributions which are made by an employer. Rather, such contributions are treated under the partnership taxation rules as either a guaranteed payment to a partner under section 707(c) or a distribution under section 731. If a partnership contributes to any employee's HSA, then such employer contributions will need to comply with the comparability rules.

There are certain individuals who do not meet the definition of "employee" and therefore they may be disregarded in the testing. Sole proprietors are not employees. An independent contractor is not an employee. A business entity, if it would so choose, is allowed to make a contribution to the HSA of an independent contractor regardless of the comparability rules. One of the pleasant surprises of the final regulation is that the comparability rules do not apply to HSA contributions which the sole proprietor makes to his or her own HSA, as a self-employed person is not an employee for HSA purposes. Therefore, the self-employed person may make an HSA contribution for himself or herself while not making any contribution for other employees, or making a smaller contribution for the employees. The IRS furnished the following example — "In a calendar year, B, a sole proprietor, is an eligible individual and contributes $1,000 to B's own HSA. B also contributes $500 for the same calendar year to the HSA of each employee who is an eligible individual. The comparability rules are not violated by B's $1,000 contribution to B's own HSA. When a sole proprietor contributes to any employee's HSA, then there will need to be compliance with the comparability rules.

Under the tax laws it is permissible for some individuals to have an HSA, an Archer MSA or to have both. The comparability rules will apply separately (i.e. a separate category) to the employees who have HSAs and the employees who have Archer MSAs. If an employee has both an HSA and an Archer MSA, the employer may contribute to either the HSA or the Archer MSA, but not to both.

How is it determined that there have been comparable contributions for comparable participating employees?

The IRS has defined the rules to provide that there will be just three categories for purposes of determining whether there has been comparable contributions for comparable participating employees. They are: current full-time employees; current part-time employees; and former employees. Full-time employees are defined as employees who customarily work 30 or more hours per week. Part-time employees are defined as those who customarily work less than 30 hours per week.

These categories are exclusive. This rule prevents an employer from defining various classes of employees and then favoring that class by making contributions to their HSAs and not to the HSAs of those in the other classes. For example, it will not be possible to make contributions just for the management class and not for the non-management class or vice versa (for the non-management class, but not for the management class.)

For purposes of these three categories and the comparability tests, the IRS has chosen to allow an employer to exclude employees who are included in a unit of employees covered by a collective bargaining agreement, if health benefits were the subject of good-faith bargaining between such employee representatives and such employer or employers. Thus, it would be permissible for an employer to have an HDHP with self-only coverage for the non-collectively bargained employees, with a deductible of $1,500, and then make a $500 contribution to all of their HSAs. Such contributions would satisfy the comparability rules because such rules do not apply to collectively-bargained employees.

For purposes of these three categories and the comparability tests, the IRS has chosen to allow an

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employer to exclude employees who are not covered by the employer's HDHP. This rule certainly simplifies the administrative tasks of the employer. The IRS has furnished the following example. "In a calendar year, Employer E offer an HDHP to its full-time employees. Most full-time employees are covered under Employer E's HDHP, and Employer E makes comparable contributions only to these employees' HSAs. Employee S, a full-time employee of Employer E and an eligible individual, is covered under an HDHP provided by the employer of S's spouse and not under Employee E's HDHP. Employer E is not required to make comparable contributions to S's HSA.

There will be times when a husband and wife work for the same employer. The IRS has written a special rule to state that the employer only needs to consider that one of them is "covered" by the employer's HDHP. That will be the spouse who has "direct" coverage under the HDHP. The other spouse is considered not covered under the employer's HDHP, and thus, the employer would not be required to make a contribution for this spouse/employee. If an employer is required to contribute to the HSAs of both spouses because it has the policy of making an HSA contribution with respect to HDHP coverage from any source, then the employer is not required to contribute amounts in excess of the annual contribution limits in section 223(b).

An employer is permitted to make HSA contributions for an employee who is not covered by the HDHP as offered by the employer, but if the employer chooses to do so, then the comparability rules will need to be met. For example, an employer may not sponsor an HDHP. However, it may have some full-time employees who are eligible individuals who have their own HSAs. An employer could choose to contribute to their HSAs, but the employer will be required to make comparable contributions to the HSAs of all full-time employees who are eligible individuals.

The comparability rules apply to contributions made by an employer to any former employee. If an employer contributes to any former employee's HSA, then it must make comparable contributions to the HSAs of all comparable participating former employees (former employees who are eligible individuals with the same category of HDHP coverage). Because the two categories of current employees (full-time and part-time) are tested separately from former employees, the comparability rules will not be violated just because the employer makes contributions of $700 to the HSAs of current employees, but chooses to contribute nothing to the HSAs of former employees. And an employer's contribution of $750 to the HSAs of current employees with self-only coverage, $1,000 to the HSAs of each current employee with family coverage, $300 to the HSAs of former employees with self-only coverage, and $400 to the HSAs of each former employee with family coverage, will satisfy the comparability rules. Note that an employer is not required to make HSA contributions if the former employee has coverage under the HDHP only because he or she made an election under the COBRA continuation rules.

An employer is also not required to make HSA contributions to a former employee who was covered by a collective bargaining agreement immediately before his or her termination of employment. As is the general rule, the employer is required to make HSA contributions to former employees only if such employees have coverage under the employer's HDHP.

In order for contributions to be comparable, and this is determined on a monthly basis for each month in a calendar year, the contributions are either the same amount or the same percentage of the deductible under the HDHP for the employees who are eligible individuals with the same category of coverage on the first day of the month. However, such amounts or percentages may differ if there are different employee classifications and different categories of the HDHP, as each is tested separately. However, with respect to the sub-categories which may exist under the family HDHP coverage, there is the rule that the contribution with respect to the "self plus two" category may not be less than the contribution with respect to the "self plus one" category, and the contribution with respect to the "self plus three or more category," may not be less than the contribution with respect to the "self plus two" category.

The rule is that there needs to be a separate comparable test for full-time employees, part-time employees and former employees. With respect to those full-time

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and part-time employees who work only part of the year, there are three contribution methods available to comply with the comparability rules. Contributions may be made on a pay-as-you-go basis, on a look-back basis or on a pre-funded basis. In general, the employer will satisfy the comparability rules for its full-time employees who work less than the full year if its contribution amount is comparable when determined on a month-to-month basis. For example, if the employer contributes $500 to the HSA of each full-time employee who works the entire calendar year, the employer must contribute $125 to the HSA of each full-time employee who worked as of the first day of a month for only 3 months out of the 12 months.

Under the pay-as-you-go method, the rules to be complied with are as follows. For each applicable category, the contributions must be the same amount or the same percentage of the HDHP deductible and must be made at the same time for each employee. However, in this situation the same time means the employer is permitted to use its usual payroll intervals, and such payments will be considered to have been made at the same time. For example, if salaried employees are paid monthly, and hourly employees are paid bi-weekly, an employer may contribute to the HSAs of hourly employees on a bi-weekly basis and to the HSAs of salaried employees on a monthly basis. An employer does have the right to change the amount that it contributes to the HSAs of employees at any point. Such change is not discriminatory as long as the changed contribution amounts satisfy the comparability rules.

Under the contributions on a look-back-basis, the comparability rules may be satisfied by making the contributions for the calendar year at the end of the year. For each applicable category, the contributions must be the same amount or the same percentage of the HDHP deductible and must be made at the same time for each employee.

Under the contributions on the pre-funded method, an employer may make contributions for the entire year to the HSAs of its employees who are eligible individuals as of the beginning of the year. The comparability rules will be satisfied under this pre-funded method even though some employees will terminate employment prior to the end of the calendar year and will receive more contributions on a monthly basis than those employees who work for the employer for the full year. The comparability rules require an employer to make comparable contributions for all employees who are comparable participating employees for any month during the calendar year, including employees who are eligible employees hired after the date of the initial funding. An employer is given three ways in which it can make contributions to eligible individuals hired after the initial funding date. The employer may also use the pre-funding method for these employees, or it may choose to the use pay-as-you-go-method or the look-back method. The same method must be used for all employees hired after the initial funding date.

There will be times when an employee has not established his or her HSA at the time the employer contributes to its employees' HSAs. Once the employee establishes his or her IRA, an employer will comply with the comparability rules by contributing the comparable contribution amount plus reasonable interest. An employer may choose to use any rate of interest which is reasonable, based on all of the facts and circumstances. However, the regulation does provide a safe-harbor rate. An employer's use of the federal short-term rate as determined by the Secretary of the Treasury in accordance with section 1274(d), is deemed to use a reasonable interest rate.

Note: Your institution will want to be aware that it is not the responsibility of the HSA custodian to determine whether or not the HSA comparability rules have been met. It is solely the responsibility of the employer. However, it would certainly be good customer service to make such employers aware of the comparability rules, as these rules must be met in order for the employer to realize the related tax benefits. CWF hereby gives you, the HSA custodian, the right to copy this article for your business customers who have or are considering having, HSAs. For your information, we also have a lobby brochure available which explains the HSA rules to employers. ◆