benefit strategies LLC

HSA GPS Fact Sheet Series

HSAs and Employer Contributions

While employers aren't required to contribute to their employees' Health Savings accounts, these deposits make HSA programs more attractive to employees by reducing their net cost of medical care (employee premium + out-of-pocket financial responsibility less employer contributions to their HSAs). In this paper, we travel to the intersection of HSAs and employer contributions to employees' HSAs to understand the rules governing these contributions.

1. Does an employer have to contribute to employees' HSAs?

No. Employer contributions are optional. Most employers provide some funding of employees' accounts, particularly in the first few years as employees build balances through their own pre-tax payroll contributions. These employer contributions make the HSA program more attractive financially.

2. What happens to employer contributions of an employee subsequently leaves employment?

HSA contributions vest immediately, except in very limited circumstances. Any contributions that an employer makes become property of the employee immediately. The employer can request that the HSA administrator return the funds only if the employee was never HSA-eligible or the employer contribution exceeded the employee's maximum annual contribution for the calendar year.

3. Must employer contributions be uniform per pay period?

No. Employers determine the amount and timing of their contributions. The most common approaches are:

- Up-front lump-sum contributions: Employees appreciate this approach because they have immediate funds to cover high expenses early in the year. Employer concerns center on company cash flow and the immediate vesting in the case of employees who leave employment early in the year.

- Flat contribution each payroll period: Employers adopt this method when they want to manage cash flow or demonstrate that HSA contributions are like pay in that they're earned each pay period. Employees with high expenses early in the year may have to pay expenses with personal funds or negotiate payment terms with their providers.

They then have the option of reimbursing themselves or paying providers from subsequent employer and employee contributions to the HSA.

- Up-front lump-sum and flat contributions each payroll period: Under this hybrid approach, an employer deposits a portion (typically 40% to 50%) of the employer contribution up front, then contributes the remainder in equal installments (either monthly or per pay period) during the year. This approach represents a compromise between providing employees with a disproportionate amount (but not all) of their annual contribution up front to apply to expenses early in the year while requiring continued employment to receive the balance.

- Periodic lump-sums: Some employers split contributions into semi-annual or quarterly deposits. This approach protects the employer from having employees depart early in the year after receiving a lump-sum contribution while minimizing the total number of deposits.

4. What documentation does an employer need to make employer pre-tax contributions?

If employers allow employees to make pre-tax payroll contributions, then both employer and employee contributions are made through a Section 125 Plan (named for the part of the tax code that allows employees to elect to receive a portion of their compensation in the form of pre-tax benefits). Employers must draft a new Section 125 Plan (sometimes called a Cafeteria Plan) or include an amendment to their current Section 125 plan to provide details on the HSA contribution program. Details include eligibility to participate in the program, total employer contribution and timing and restrictions on employee changes to their elections.

5. How much do employers contribute when an employee becomes HSA-eligible mid-year?

Employers address this topic in the portion of the Section 125 Plan that discusses employer HSA contributions. Employers can choose to make new hires "whole," ensuring that they receive as much as full-year employees because they face the same deductible. Alternatively, they can pro-rate a lump-sum contribution or simply start contributing the pro-rated amount per pay period or other milestone. It's important that the employer spell out its policy and administer it consistently for all employees.

6. Can employers make matching contributions to employees HSAs?

Yes. Few employers have taken advantage of this provision, but the IRS rules allow it. Matching contributions are a great way for employers to encourage employees to make regular contributions to their HSAs. Building balances is important for employees who may face an unexpected cost in the near future. Also, contributions allow employees to build medical equity – financial assets that they can tap for tax-free reimbursement of eligible expenses at any point in the future.

7. Are employer contributions subject to Section 125 nondiscrimination testing?

Yes. Under a Section 125 Plan, contributions directly from the employer and employee pre-tax payroll contributions are collectively labeled employer contributions. They are subject to Section 125 Plan nondiscrimination testing, which seeks to ensure that the plan doesn't disproportionately favor highly compensated employees.

8. What happens if a plan fails the nondiscrimination testing?

Usually a plan can come into compliance if highly compensated employees reduce their pre-tax payroll deduction. These individuals then can make personal (after-tax) contributions to their HSAs. They can deduct these contributions from their taxable income when they complete their personal income tax returns.

9. How are contributions reported?

Contributions through the Section 125 plan – both employer and employee pre-tax payroll contributions – are summed into a single figure in Box 12 of Form W-2, which employers prepare by Jan. 31. Form W-2 doesn't break down employer vs. employee pre-tax payroll contributions. This breakdown is irrelevant to tax reporting, since they're treated the same for income tax purposes. Also, HSA administrators issue Form 5498-SA by May 31 every year. This form lists total contributions from all sources and the fair-market value of the account.

10. What are the rules around employer contributions if they don't allow employees to make pre-tax contributions?

This situation is uncommon. Most employers allow employees to make pre-tax contributions because employers save on federal payroll (FICA) taxes, employees contribute consistently and employee contributions are on a pre-tax basis. If the employer doesn't allow pre-tax contributions, employer contributions are subject to comparability rules. Under comparability rules, employers can divide their employee populations into no more than three classes: full-time, part-time and former. They can offer different contribution levels (including zero) to different classes, but they must treat everyone within a class comparably by providing either a flat-dollar contribution regardless of contract type or a contribution equal to a percentage of the deductible for both self-only and family contracts. Failure to follow the rules exposes employers to an excise tax equal to 35% of their total contribution to all employees' HSAs during the plan year.

This information is accurate as of September 23, 2016. Please note that this discussion is for informational purposes only and is based on current regulations. It doesn't represent, and shouldn't be construed as a substitute for, professional advice. Please consult your personal legal, financial or tax counsel to discuss your personal situation and refer to IRS Publication 969.

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