



## HSAs and Employer Contributions

Employers aren't required to contribute to their employees' Health Savings Accounts (HSAs). Many do contribute, however, as these deposits make HSA programs more attractive to employees by reducing their net cost of medical care (employee premium plus 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, especially when the employer offers multiple medical coverage options.

### **2. What happens to employer contributions if an employee subsequently leaves employment?**

HSA contributions vest immediately. All employer contributions become property of the employee when they are deposited in the account. An employer can't calculate a pro-rated amount and withdraw that amount from a departing employee's HSA or withhold that amount from the final paycheck.

The employer can request that the HSA administrator return employer contributions only if (1) the employee was never HSA-eligible or (2) the employer contribution alone exceeds the employee's statutory maximum annual contribution for the calendar year (\$3,500 for self-only and \$7,000 for family coverage in 2019).

### **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 have immediate balances 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 another form of compensation that employees earn each pay period. Employees with high expenses early in the year may have to pay providers with personal funds or negotiate payment terms with their providers. They then can reimburse themselves or pay providers from subsequent employer and employee contributions to the HSA.
- Up-front lump-sum and then 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 deposits the remainder in equal installments during the year. This approach allows employers to deposit a disproportionate amount (but not all) of their annual contribution up front so that employees have some seed money to manage expenses early in the year. This approach requires participants to continue their employment and enrollment in the plan 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 the full employer contribution and minimizes the total number of deposits (versus per-paycheck contributions).

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

If employers allow employees to make pre-tax payroll contributions, both employer and employee contributions are made through a Cafeteria Plan (sometimes called a Section 125 plan 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 Cafeteria Plan document or include an amendment to their current Cafeteria 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 Cafeteria Plan that covers employer HSA contributions. Companies 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 prorate 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 Internal Revenue Service (IRS) rules allow it when contributions are made through a Cafeteria Plan. Matching contributions are a great way for employers to encourage employees to make regular contributions to their HSAs as they typically do with an employer-sponsored retirement plan. 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 qualified expenses at any point in the future, including during retirement.

## **7. Are employer contributions subject to Cafeteria Plan nondiscrimination testing?**

Yes. Under a Cafeteria Plan, employer contributions and employee pre-tax payroll deductions are collectively labeled *employer contributions*. They are subject to 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?**

When the test is conducted early in the year, an employer can usually bring the program into compliance by requiring highly compensated employees to reduce their pre-tax payroll deductions. These employees can then make personal (after-tax) contributions to their HSAs. They can deduct these contributions from their taxable income when they complete and file their personal income tax returns. Deducting personal contributions allows these employees to recover their federal and state (if applicable) income taxes paid on the funds, but not FICA taxes paid by employer and employee. In the case of most highly compensated employees, their effective FICA tax rate is 1.45% each for employer and employees, since their incomes generally exceed the ceiling for the 6.2% (each) Social Security component of the payroll tax. The ceiling, which is adjusted annually for inflation, is \$132,900 in 2019 (up from \$128,400 in 2018).

## **9. How are contributions reported?**

Contributions through the Cafeteria Plan, both employer and employee pre-tax payroll contributions, are reported as *employer contributions* and reported as a single figure in Box 12 of Form W-2. Employers deliver Form W-2 to employees by Jan. 31.

Also, HSA administrators issue Form 5498-SA by May 31. This document lists total contributions from all sources and the fair-market value of the account. Your administrator may issue a preliminary Form 5498-SA by Jan. 31 to assist you in completing Form 8889, which you submit with your personal income tax return. The final Form 5498-SA isn't issued until the end of May because you can contribute to your HSA for a tax year up to the due date of your personal income tax return without extensions for that year (April 15 in 2019).

**10. What rules apply to employer contributions if employers don't allow employees to make pre-tax contributions?**

This situation is uncommon. Most employers allow employees to make pre-tax contributions.

If the employer doesn't, employer contributions are subject to comparability rules. Under these 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 each class. They must treat everyone within a class comparably by providing either a flat-dollar contribution to each employee 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.

**11. Can employers require substantiation of expenses associated with their contributions to employees' HSAs to ensure that employer funds are distributed for qualified expenses only?**

No. Neither employers nor HSA administrators can require documentation to substantiate an expense. HSA owners can withdraw funds for any purpose. They're responsible for managing their accounts in compliance with IRS rules. Besides, once funds from whatever source – including an employer – are deposited in an HSA, they become property of the HSA owner because they vest immediately. There is no accounting of *employer* and *employee* contributions, as there are in an employer-sponsored retirement plan to reflect a vesting schedule.

*This information is accurate as of Nov. 5, 2018. 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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