HSAs and Employer Contributions

Employers aren't required to contribute to their employees' Health Savings Accounts (HSAs). Many do so, 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 account).

In this paper, we travel to the intersection of HSAs and employer contributions to employees' HSAs to understand the rules governing these contributions.

Does an employer have to contribute to employees' HSAs?

No. Employer contributions are optional. Most employers provide some funding of employees' accounts, particularly during the first few years as employees build balances through their own pre-tax payroll contributions. These employer contributions make the program more attractive financially, especially when the employer offers multiple medical coverage options.

What happens to employer contributions if an employee subsequently leaves employment?

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 account or withhold that amount from the final paycheck. The employer can request that the administrator return employer contributions only if:

1. The employee was never HSA-eligible
2. The employer contribution alone exceeds the employee's statutory maximum annual contribution for the calendar year ($3,650 for self-only and $7,300 for family coverage in 2022).

Must employer contributions be uniform per pay period?

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

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 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.

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 upfront, then deposits the remainder in equal installments during the year. This strategy allows employers to deposit a disproportionate amount (but not all) of their annual contribution upfront so that employees have some seed money to manage expenses early in the year. Employees must remain employed and enrolled 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).

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

If employers allow employees to make pre-tax payroll deductions, both employer and employee contributions are made through a Cafeteria Plan (sometimes called a Section 125 plan). Employers must draft a new Cafeteria Plan document or include an amendment to their existing plan to cover the HSA program. Details include eligibility to participate, total employer contribution, and timing and restrictions on employee changes to their elections.

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 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 pro-rate a lump-sum contribution or simply start contributing the pro-rated amount per pay period or other timing. It's important that the employer spells out its policy in the Cafeteria Plan and administer it consistently for all employees.

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.

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.

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.

How are contributions reported?

Contributions through the Cafeteria Plan, both employer and employee pre-tax payroll deposits, are reported as employer contributions and appear as a single figure in Box 12 of Form W-2. 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 January 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 personal income tax returns.

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.

Can employers require substantiation of expenses associated with their contributions to employees' HSAs to ensure that employer funds are distributed for eligible 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. Once funds are deposited into an HSA (including employer contributions), they become property of the HSA owner because they vest immediately. There is no accounting of employer and employee contributions, like there is in an employer-sponsored retirement plan, to reflect a vesting schedule.