HSA Programs for Groups: Employer Versus Employee Responsibilities

Employers implementing a health savings account (HSA) program face a shared compliance burden with their employees. The law dictates that all HSAs are individual accounts that must be opened by an Internal Revenue Service (IRS)-approved custodian or trustee. The individual account features combined with a required third-party custodian place much of the compliance burden for HSAs on the employee and custodian rather than the employer. Employees are compensated for the additional burden because HSAs give them more control over their health care money, and employers are generally pleased with their own reduced compliance burden. The shared compliance responsibilities, however, create confusion and misunderstanding for both employers and employees. This article distinguishes between the responsibilities of the employer and the employees for HSAs.

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Health savings accounts (HSAs) are individual accounts. Most of the laws and rules governing HSAs build on this foundational premise. The money in the HSA belongs to the individual HSA owner, the HSA owner decides when and how to use the funds, and HSA's tax benefits flow to the HSA owner. Given the focus on the individual with HSAs, some HSA providers and employers implement an HSA program for an employer group the same as if a number of individuals were just opening HSAs at the same time. This approach can work provided the employer understands the relatively few rules that apply on the group level and the employees understand their responsibilities. This article distinguishes between the responsibilities of the employer in implementing an HSA program versus the responsibilities of employees.

Group Plan Defined

The relative lack of group-level rules significantly simplifies HSA implementation and ongoing administration for employers. In some cases, employers will not encounter any employer or group HSA rules and can leave the compliance burden entirely at the employee level. The point at which HSA group rules apply is based on the definition of an *employer HSA program.*

TABLE I

Avoidance of Taxes on HSA Contributions, by Contribution and Tax Type

Tax	Avoidance: Pretax Employer	Avoidance: Employee on Own
Federal income tax	√	√
State income tax*	√	√
FICA	√	
Medicare	√	
FUTA	√	
SUTA*	√	

*Depends on state law (Alabama, California and New Jersey do not allow state HSA deductions).

The law does not use the commonsense definition of *group* as "more than one," but instead applies special rules to employers making pretax HSA contributions into employee HSAs. Accordingly, the HSA group-level rules can apply even if an employer has only one employee who receives a pretax HSA contribution. Conversely, an employer with many employees having HSAs is not subject to the HSA group rules provided the employer allows only after-tax payroll contributions to the HSAs or no contributions at all.

Employers that offer high-deductible health plan (HDHP) coverage to employees face the issue of whether and how to implement an HSA program. Employers that offer no assistance for HSAs or offer only after-tax HSA payroll deferrals are often struggling just to pay a portion of employee health insurance and lack the ability to add additional funds to employee HSAs. An employer in this position is capitalizing on the unique benefit of HSAs in health benefits law: that individuals can open and contribute to an HSA without employer involvement and still get a tax break. Without much expense other than the additional compliance burden, however, these employers could offer pretax payroll deferral into an HSA, giving employees a substantial additional benefit. HSAs are tax-driven accounts, and not offering pretax HSA contributions reduces this main benefit for both employees and employers.

Tax Benefits for Employer HSA Contributions

Employers that allow pretax HSA contributions maximize the tax benefits for their employees and the business. The main tax benefit for employees is the income tax deduction. Employees get this deduction regardless of whether the company makes the contribution pretax or posttax, or the employee makes the contribution directly. The additional tax savings from employer pretax contributions come from payroll taxes: Social Security and Medicare (the Federal Insurance Contributions Act, or FICA), Federal Unemployment Tax (FUTA), and possibly State Unemployment Tax (SUTA). Both employer-direct contributions and pretax payroll deferral HSA contributions avoid payroll taxes (Table I). The savings achieved by avoiding payroll taxes are worth some effort. FICA is 6.2% up to $106,800 on the employer side and another 6.2% for the employee side (4.2% special reduced rate for 2011 and 2012). Medicare is an additional 1.45% for both the employer and the employee on all income. FUTA is relatively small, and only the employer pays it (generally 0.8% on the first $7,000), but there may be savings for SUTA as well.

Section 125 Plan Required for Payroll Deferral

Employers that want to allow employee pretax payroll deferrals into an HSA must establish a Section 125 plan.[1] Section 125 plans, or *cafeteria plans*, are relatively easy to establish and generally do not require the employer to submit any paperwork to the Internal Revenue Service (IRS) or an annual IRS Form 5500 filing. The "cafeteria" name fits because the plans generally offer a choice of tax-deferred benefits: accident and health insurance, dependent care, adoption assistance, group term life insurance and HSA contributions. Many employers already have a Section 125 plan because the plan is necessary in order to allow an employee to pay a portion of the health insurance premium pretax. In that case, the employer needs to confirm that the plan allows for HSA deferrals. If not, the plan provider can likely add the necessary language for a small fee.

A Section 125 plan is a written legal document that the employer signs, maintains and administers. By signing the document, the employer agrees to comply with the rules contained in the document regarding types of benefits allowed, treating employees fairly and other IRS requirements. The maintenance of the document itself generally means updating the document periodically to comply with law changes as well as keeping the signed copy on file in case of an IRS audit. Administering the Section 125 is where the work occurs.

For payroll deferral into an HSA through a Section 125 plan, the employer must reduce the employees' pay by the amount of the deferral and contribute that money directly into the employees' HSA. The employer may do this administration itself or it may use a payroll service or another type of third-party administrator. In any case, the cost of the Section 125 plan itself and the ongoing administration are generally small and offset, if not entirely eliminated, by employer savings through reduced payroll taxes.

Another administrative element is the collection of Section 125/HSA payroll deferral election forms from employees. Employers that have offered Section 125 plans prior to introducing an HSA program are familiar with this process. Unlike other Section 125 plan deferral elections that allow only annual changes, the law allows for changes to the HSA deferral election as frequently as monthly. Although frequent changes to the elections create a small administrative burden for the employer, the benefit to employees is significant.

The ability to change deferral elections allows employees to adjust midyear to what the year's expenses actually are versus what they planned for. An employee who initially expected a low-expense, healthy year, and elected only a small HSA payroll deferral, can adjust when surprised by a large medical expense. Conversely, an employee who elected to defer a large amount into the HSA but later faces lower than anticipated medical expenses (or faces higher than anticipated nonmedical expenses) can adjust his or her deferral downward. Employers are allowed, but not required, to accept prospective monthly changes to deferral elections. *Prospective* means that the change cannot take effect until the month following the change date.

Offering pretax HSA payroll deferral makes sense for most employers that provide an HSA-eligible health insurance program. The cost, compliance and administrative burdens are low compared to the tax benefits for the employer and the employees. Employers can obtain these same tax benefits without a Section 125 plan by giving money to the employees rather than using employee payroll deferral; however, then the employer must meet the comparability rules.

Comparability Testing

The most complicated compliance issue facing employers adopting HSA plans is comparability testing. Congress created the concept of *comparability* to ensure that employer-provided HSA contributions are made on a fair basis across employee groups. Those familiar with 401(k) plan discrimination testing understand the nature of these types of rules and the accompanying complexity. The comparability rules are long, difficult and sometimes counterintuitive. And, the government imposes a severe 35% penalty for failure to comply. One positive attribute of the severity of the penalty is that most employers are aware of this rule.

The burden of meeting the comparability rules is more than offset by the tax advantages. Employers meeting the comparability rules can deduct the amount of the HSA contribution as a business expense.[2] Neither the employer nor the employee has to pay payroll taxes on the contribution. The employee avoids federal income taxes and, in most cases, state income taxes.

Although the IRS regulation includes the term *comparability testing*, the term refers to ensuring that the contributions are comparable at the time made. There is no need to test later. This simplifies the rule as compared to other benefit plan testing that occurs after the end of the period, when corrections are more difficult. Also, employers are not required to submit the results of the comparability testing to the government, except possibly as part of an IRS or other government agency audit.

The lengthy regulations lend themselves to three steps.

First—Does Comparability Testing Apply?

Employers should first question whether the rule applies. The rule applies only if an employer makes pretax contributions to an employee's HSA outside of a Section 125 plan (i.e., when the employer gives money to employees' HSAs).

Given tough economic times, many employers choose not to contribute directly to their employees' HSAs and instead offer only an HSA payroll deferral option to allow the employees to self-fund the HSA through a Section 125 plan. In this case, the comparability rules do not apply because the law provides an exception for HSA contributions made through a Section 125 plan. This is an important exception to the comparability rules and applies to all contributions made through a Section 125 plan. This exception allows for some planning opportunities, where employers may use a Section 125 plan rather than contribute directly to the employees' HSAs, in order to avoid the comparability rules.

Once the employer has determined that comparability does in fact apply, the next step is to determine the categories that must be treated comparably. The comparability rules do not require that everyone get comparable treatment, just comparable treatment for employees in the same category.

Second—Are Employees Properly Categorized?

Once the employer has determined that comparability does in fact apply, the next step is to determine the categories that must be treated comparably. The comparability rules do not require that everyone get comparable treatment, just comparable treatment for employees in the same category. The IRS provides clear guidance on the acceptable categories and does not allow for employers to create additional categories. The following are *all* acceptable categories:

- Part-time versus full-time
- Current versus former
- HSA-eligible versus noneligible
- Nonunion versus union (and union versus union)
- Employer-provided HDHP versus other HDHP
- Single HDHP coverage versus family coverage
- Within family: self plus one, self plus two and self plus three or more (cannot decrease amount as family size increases)
- Non-highly compensated (must not get less, but can get more) versus highly compensated (cannot get more).

The employees within the same category must be treated comparably. The categories are listed as one group versus another to illustrate that the rule allows employers to treat these groups differently. For example, an employer can treat part-time employees differently from full-time employees without worrying about any relationship between the two groups (e.g., an employer can give full-time people a generous HSA contribution and nothing to part-time people).

There are two exceptions to this general rule. First, for non-highly compensated versus highly compensated employees, the comparability rules allow the groups to be treated differently so long as non-highly compensated employees get a larger HSA contribution than highly compensated employees. The second exception follows the same logic. Employers are allowed to make different-sized contributions to the subcategories within the family category (self plus one, self plus two and self plus three or more) as long as the contribution amount does not decrease as the family size increases.

A very common use of the ability to treat separate categories of employees differently is for employers to treat family HDHP-covered employees differently than single HDHP-covered employees. A couple of examples illustrate the power of the exception in planning and allowing employers flexibility in how to operate their HSA program.

1. **Reward single employees example.** Tom's Toys offers its employees a choice of family HDHP coverage and self-only HDHP coverage. Employees who select self-only HDHP coverage cost the company less money. To reflect the cost savings, Tom's Toys decides to give each em-

ployee who selects self-only coverage a $200 per month contribution to an HSA. Tom's Toys decides to make no HSA contribution for family-covered employees. Even though the amounts are not the same, this meets comparability rules because single HDHP coverage and family HDHP coverage are two separate categories and the rules allow discrimination between categories.

2. **Provide more for families example.** Assume the same facts as above, except Tom's Toys changes management. The new management believes family HDHP-covered employees need a larger HSA contribution because with more people covered by the insurance, they are more likely to need additional health care dollars. The new management changes the next year's HSA contribution to $200 for each employee with family HDHP coverage and no HSA contribution for self-only covered employees. Although this approach is the exact opposite of the first example, it also meets the comparability rules for the same reason.

No other categories are allowed, including the following:

- Management employees versus nonmanagement
- Age-based
- Wellness plan participation-based
- Length of service-based
- Any other category not specifically allowed.

Employers often desire to favor management over nonmanagement employees. This is not a permissible category, and this rule prevents employers from making larger HSA contributions for management versus nonmanagement. Employers may desire to allocate larger HSA contributions to older employees, possibly to reflect the larger catch-up contribution allowed for those ages 55 to 65, but age is not a permissible category. The list of nonpermissible categories is endless. The IRS states the only permissible categories.

Third—Are the Contributions Comparable?

The final step is to ensure that the group is making comparable contributions to employees in the same category. Comparable contributions within a category means the employer must either contribute the same dollar amount or the same percentage of the deductible. This step is generally simplified because many employers elect to give comparable employees the same dollar amount. Employers offering a choice of HDHP insurance plans may use the same percentage method instead of the same dollar amount.

For example, Tom's Toys offers two HDHP plans: Plan A with a $2,500 deductible and Plan B with a $3,500 deductible. Tom's Toys plans to make an HSA contribution for its employees and is considering making a $1,500 contribution to all employees in the same category, or giving different amounts depending on the deductible. Under the percentage of the deductible method, Tom's Toys would give each employee 50% of the deductible, so Plan A participants would receive a $1,250 HSA contribution and Plan B participants would receive $1,750. These choices meet the comparability rules.

Timing of Contributions

Employers often misunderstand how timing of the contributions impacts comparability testing. The IRS provides three methods for making HSA contributions: prefunding, periodic funding, and "look-back" or postfunding.

Prefunding is when an employer puts in the full year's HSA contribution upfront. Employers may desire to do this as a benefit to employees who may need the money early in the year or in a desire to complete the administration of the HSA early in the year. This method works with some limitations. First, if an employee quits midyear, the employer cannot recoup any contribution made to the employee. Second, if a new employee is hired midyear, the employer is required to treat the new employee comparably, generally requiring a contribution for that employee. That employee would be entitled to a pro-rata HSA contribution based on the months of eligibility. The employer can make that contribution monthly or wait until the end of the year to contribute.

Periodic funding is recommended for most groups. *Periodic funding*, generally monthly, allows for employees to get access to funds on a regular basis and limits adjustment to new hires or employees who separate from service. Monthly contributions are generally preferred because the IRS works on a monthly basis for comparability purposes. More frequent contribution schedules, weekly or semimonthly, also work well, as they allow for a monthly determination. Depending on the HSA contribution amount, the more frequent schedule can result in an increased amount of administrative work for a small dollar contribution amount. Less frequent contributions—for example, quarterly—are generally better categorized as *pre-* or *postfunding*, given the need for adjustment for new employees.

The IRS allows for funding to occur at the end of the year as well. This allows for employers to easily adjust for new hires and employees separating from service, but most employees are not satisfied with a system that requires them to wait until the end of the year to receive the HSA funding.

Another common desire of businesses, especially small businesses, is to give the owners who also work in the business a larger contribution than nonowner employees. Surprisingly, this may be allowed under the comparability rules for some small business entities, but only because the HSA contribution is treated as a shareholder distribution rather than an HSA contribution.

Small Business Owner Issues

Small business owners face special HSA rules that limit the owners' ability to get tax benefits through the company. Although a business can usually deduct HSA contributions for employees as a business expense, and the HSA contributions do not get reported as income to the employees, the rules are different when a business makes HSA contributions to its owners. The treatment varies by type of business entity:

- **Sole proprietors.** A sole proprietor is not considered an employee for the purposes of business-made HSA contributions.[3] Accordingly, sole proprietors are not allowed to deduct their own HSA contributions as a business expense. Instead, sole proprietors can deduct HSA contributions on their personal income tax return. Amounts contributed on behalf of employees generally are deductible as a business expense. This tax treatment may result in the sole proprietor having to pay payroll taxes on the owner's HSA contribution. One positive of this different treatment is that the owner's contribution is not subject to the comparability rules. This allows a sole proprietor to give himself a more generous HSA contribution than he gives his employees.
- **Partnerships and LLCs.** Partnerships and multimember limited liability companies[4] are generally treated as flow-through entities for purposes of HSA contributions made on behalf of the owners. That is, HSA contributions to the owners are not deductible by the business but flow through to the owner as a distribution to the partner.[5] The HSA contribution would be reported as a distribution of money on the partner's Schedule K-1, and the partner can then take a deduction for the HSA contribution on the partner's personal income tax return.
- For this reason, partnerships and LLCs often choose to make a larger shareholder distribution for the owners and let the owners make HSA contributions on their own rather than have the business do it directly. The tax treatment is the same. Contributions made pursuant to a Section 125 plan will be added back to the owners as a taxable fringe benefit, negating any tax benefit they might have otherwise received from a Section 125 plan.
- An exception exists for guaranteed payments to partners. If a partner is entitled to a guaranteed payment from the partnership, the HSA contribution is deductible by the partnership as a business expense.[6] Unlike for nonowner employees, the HSA contribution is also reported as income pursuant to a guaranteed payment on the partner's K-1, and the partner can then deduct the HSA contribution on his or her personal income tax return.

  —**S-corporations.** Owners of more than 2% of an S-corporation are treated as partners in a partnership. Contributions made for services rendered are treated as guaranteed payments, following the same process for partnership guaranteed payments noted above. S-corporation HSA contributions to owners may avoid employment taxes.[7] Owners also cannot make pretax contributions to their HSA via a salary reduction. Any contributions made on their behalf

TABLE II

HSA Reporting Requirements by Responsible Party

HSA Reporting Requirement	Responsibility		
	Custodian	Employer	Employee
Payroll deferral HSA contribution	5498-SA	W-2	8889
Employer contribution	5498-SA	W-2	8889
Employee contribution made personally	5498-SA	None	1040 and 8889
HSA distribution for medical expenses	1099-SA	None	8889
HSA distribution for noneligible reason	1099-SA	None	1040 and 8889

by the corporation are taxable and may be deducted on their personal income tax.

—**C-corporations.** Shareholders of normal corporations, C-corporations, who are also employees are not subject to any special HSA rules and are treated as employees.

Some small business owners are surprised by the different tax treatment of owners versus employees. Small business owners making comparable contributions to nonowner employees under the comparability rules can take a deduction for the amount contributed to employees' HSAs. Beyond just the reporting differences, the key distinction between the treatments of owners versus employees is payroll taxes. Employer pretax HSA contributions avoid the payroll taxes. Employer contributions to small business owners, however, do not automatically avoid payroll taxes, and the amounts contributed to the HSA are taxed as shareholder distributions and likely to be subject to payroll taxes.

HSA Custodian Required

Given that HSA dollars must be held by an approved HSA custodian or trustee, generally a bank, an employer is relieved of many of the trust and fiduciary obligations found in other benefit programs. The HSA custodian performs the accounting function of tracking deposits and distributions. Given the employer's limited role, employer-based HSA programs are generally not subject to ERISA. This relieves employers of the burdens ERISA imposes and the requirement to file an annual IRS Form 5500.[8]

Government Reporting Obligation

The custodian performs the government reporting function of sending contribution reports (IRS Form 5498-SA) and distribution reports (IRS Form 1099-SA) to both the IRS and the HSA owner.

For reporting purposes, the employer reflects pretax HSA contributions, both employer and employee payroll deferral, as nontaxable income on the employees' W-2. Employer contributions and payroll deferral are added together to reflect one number in box 12 of the W-2 using a Code W (Table II). The employer can deduct the amount on its tax return under the deduction for contributions to an accident and health plan (Code Section 106(d)), a special code section for HSAs and for employee contributions made through payroll deferral pursuant to Code Section 125.

The IRS uses both the employer-provided W-2 information and the custodian-provided 5498-SA information to ensure that the employee does not claim a double deduction for the HSA contribution, both by receiving it pretax through the company and then claiming a personal deduction as well.

General Administration of HSA

The custodian also provides the legal document, the custodial agreement (IRS Form 5305-C), that sets forth the basic

TABLE III

HSA Compliance Requirements by Responsible Party

HSA Compliance Requirement	Responsibility Employee	Employer	Custodian
Eligibility for HSA	√		
Contribution limit	√		
Distributions—deciding and validating what is eligible	√		
Open HSA	√		
Management of HSA (monitor balance, maintain contact information, select investments, etc.)	√		
Termination of employment—close HSA	√		
Employer contribution—comparability		√	
Employee payroll deferral—§125 plan rules		√	
Small business owner rules		√	
Accounting—custodial services (track activity, accept beneficiary information, etc.)			√
HSA legal documentation—5305-C	√		√

legal terms of HSAs and generally serves as the first line of contact for both account administration (changing contact information, adding beneficiaries, checking account balance, etc.) and answering basic HSA questions.

The employer's main administration function is actually making the HSA contributions. This may be done electronically or by sending a check along with a spreadsheet with information allocating the contribution. A key legal issue for employers in this area is that the HSA rules are very strict regarding "recouping" HSA contributions from the employee's HSA. With limited exceptions, once the employer's HSA contribution is put into the employee's HSA, the custodian is not allowed to give the money back directly to the employer. The lesson here for employers is to get the contribution amount correct prior to making the contribution. There are also special rules for employees who fail to open an HSA, requiring the employer to hold the funds for a limited period of time to allow the employee an opportunity to open an HSA.

Employee's Responsibility

The bulk of the compliance burden for meeting the HSA rules rests with the individual (Table III).

Substantiation

The individual must substantiate that the distributions from the HSA were, in fact, used for eligible medical expenses by saving medical receipts in case of an IRS audit. Shifting this burden to the individual relieves the employer of the arduous task of reviewing receipts and issuing reimbursement checks or otherwise facing some potential liability for failure by an employee to use the money appropriately.

Eligibility

Although an employer and a custodian can help educate employees on the requirements for being eligible for an HSA, the ultimate responsibility for determining eligibility rests with the HSA owner. An employee's participation in a spouse's health insurance plan or flexible spending account (FSA) could jeopardize the employee's HSA eligibility, as could participation in a government health care system, such as the Veterans Administration's plan or Medicare.

Maximum Contribution Limit

The individual is primarily responsible for ensuring that the amount contributed to the HSA is within federal guidelines. Employers and custodians share a bit of the responsibility; employers cannot deduct more than the maximum HSA contribution limit for an employee, and custodians cannot accept more than the family HSA limit plus one catch-up contribution ($7,150 maximum for 2011). An employee who exceeds the limit may cause additional administrative work for the employer, the custodian and the individual, so it is in everyone's best interests to educate the employee on the limits.

Management of HSA

Employees manage the balance in the HSA, select investments, choose beneficiaries and perform other maintenance issues without employer involvement.

Tax Payments

HSA owners are required to file an attachment, IRS Form 8889, to their income tax return each year they make a contribution or take a distribution. This form is used by the IRS to ensure that the individual does not take a larger-than-permitted deduction and also ensures that the individual pays any taxes and penalties owed for noneligible distributions.

Termination of Employment

Another positive feature of HSAs for both employers and employees is that the HSA remains open and viable after the employee's separation from service. Other than discontinuing any contributions into the HSA, the employer does not need to take any action regarding the separating employee's HSA.

Conclusion

Employers implementing HSA programs for employees can take comfort in the fact that much of the legal and compliance burden for HSAs falls on the employee or the HSA custodian, not the employer. This simplifies HSA programs for employers and increases their desirability for both employers and employees. This shift in responsibility does not mean employers are relieved of all compliance burdens, nor does it mean that employers do not play a role in educating employees about the employees' responsibilities. Employers are best served by fully understanding the rules and assisting employees to do the same in order to maximize any HSA program offered.

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Endnotes

1. A plan that meets the requirements of Section 125 of the Internal Revenue Code.
2. IRC §106(d).
3. CFR §54.4890 G-3, Q&A 2.
4. Single member LLCs are treated the same as sole proprietor LLCs.
5. LLC tax treatment varies by state and this discussion does not include LLCs that have elected to be treated as corporations rather than partnerships.
6. IRC §162.
7. IRS Notice 2005-8, see Q&A 3 noting that if the requirements of IRC §3121(a)(2)(B) are satisfied, then the wages are not subject to employment taxes.
8. U.S. Department of Labor, Field Assistance Bulletin 2004-1.