Legal Pitfalls in Employer-Based Health Savings Accounts

Ways Hospital Employers Can Avoid Common, Costly Mistakes

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In an attempt to control the rising costs of health care, Congress passed a law in 2003 allowing an individual covered by a high-deductible health plan (HDHP) to contribute money to a health savings account (HSA) and use those funds to pay unreimbursed health care expenses. Congress hoped that HSAs would give health care consumers more "skin in the game" and cause them to avoid unnecessary costs.

Following Congress’ actions, the use of HSAs has exploded. Many employers facing increased workforce health care expenses established HDHPs and began making contributions to HSAs for the benefit of their employees. In many cases, however, those employers may not have fully considered the legal requirements and limitations on employer-based HSA arrangements. As discussed in this article, employers that are not careful can be hit with significant monetary penalties, including a 35% excise tax to the IRS.

HSAs in General

Only individuals covered by an HDHP (deductible of at least $1,250 for single and $2,500 for family coverage in 2014) are eligible for HSA contributions. Both the employee and employer can contribute on a pre-tax basis to the HSA, for a combined limit of $3,300 for single and $6,550 for family coverage during 2014. Individuals age 55 or older may make additional annual contributions of $1,000.

Amounts contributed to an HSA, including employer contributions, are vested at all times and owned by the employee. Unused amounts carry over indefinitely, even after the employee terminates employment. Employer contributions to an HSA of an eligible employee are excludable from the employee’s income, and an employer may allow employees to make pre-tax contributions to an HSA through the employer’s cafeteria plan. HSA funds grow on a tax-deferred basis and, if used to pay eligible medical expenses, are free from taxation upon distribution.

Comparability Rules

Perhaps the most problematic aspect of employer-sponsored HSA programs is the comparability rules. Under the Internal Revenue Code, employer HSA contributions must be made on a comparable basis for all comparable participating employees. The only categories of employees approved by the IRS for comparability testing are:

- current full-time employees,
- current part-time employees (defined as employees working fewer than 30 hours per week) and
- former employees.

Contributions are comparable if they are either of the same amount or the same percentage of the deductible for the applicable plan. An employer may, however, make larger contributions to the HSAs of all non-highly compensated employees (NHCEs) who are comparable participating employees than to the HSAs of highly compensated employees (HCEs) who are comparable participating employees.

For these purposes, an HCE is an employee making above the limit under section 414(q) of the Internal Revenue Code (generally, $115,000 in 2013). The comparability rules generally do not apply to collectively bargained employees and contributions made through a cafeteria plan.

It is easy to trip up on the comparability requirement. For example, an employer working with a limited health care budget may wish to provide an annual $250 HSA contribution solely to non-management NHCEs, or perhaps solely to employees making under $50,000. Unfortunately, both of these arrangements would violate the comparability rules because these are not IRS-approved categories of employees. As another example, an employer may wish to make lower contributions for part-time employees working less than 35 hours per week. This contribution formula would violate the comparability rules because those rules require that part-time employees be defined as those working less than 30 hours per week.

Many employers currently have HSA contribution arrangements that violate the comparability rules. Employers who violate the comparability rules face an excise tax of 35% of the aggregate amount contributed by the employer to HSAs. Because these rules are easy to break and the penalties are very high, employers are strongly encouraged to review their arrangements.

Other Considerations

Besides complying with the comparability rules, there are other tax considerations for employers with HSAs. Employers must report employer HSA contributions on Box 12 of Form W-2. Also, HSA contributions made through a cafeteria plan are subject to the nondiscrimination testing rules applicable to cafeteria plans.

Now might be a good time to examine whether your HDHPs and HSAs are meeting their intended goals. Most employers adopted HDHPs and HSAs with the hope that employees would become better consumers. Recent studies, however, raise doubts about whether or not these programs actually produce cost savings. Some employees with HDHP coverage may skimp on care they need, which can increase costs in the future. Also, shopping among health care providers and haggling for better prices remain, at best, difficult processes.

Employers should also consider whether there are other programs that would accomplish their goals more effectively than HSAs. For example, health care reimbursement arrangements (HRAs) are similar to HSAs, but the funds are owned by the employer rather than the employee, so that employees who leave employment do not take the funds with them.

On a more positive note, HSAs remain one of the most tax-advantaged programs currently available in the United States. In fact, they are triple-tax favored. Individuals get an above-the-line deduction for contributions, the investment growth of the funds is not taxed, and there is no taxation for withdrawals used for medical expenses (including retiree medical expenses). These tremendous tax advantages should be given strong consideration by employers analyzing health care options, and the benefits should be emphasized to employees.

With the continued implementation of health care reform, now is a good time for employers to revisit their benefit programs and ensure that the programs are both complying with all legal requirements and meeting the company’s goals. This is especially true for HSAs. Employers are encouraged to talk with their benefit advisors about legal compliance and practical considerations for HSAs and determine if these programs remain the best option for the company and its employees.

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