What Employers Should Know about HSAs

Health Savings Accounts (HSAs) are a tax-smart way to cover an individual's uninsured medical expenses, as well as certain other out-of-pocket medical, dental, vision, hearing, long-term care expenses and insurance premiums. Your business can set up HSAs for qualifying employees. Then the business can fully or partially fund the accounts or let employees fund them with salary-reduction contributions.

From a practical standpoint, it's probably too late to add HSAs to your benefits package for 2019, but next year is right around the corner. Here's what you need to know about employer-sponsored HSAs.

The Basics

Under the Affordable Care Act, health insurance plans are categorized as Bronze, Silver, Gold or Platinum. Bronze plans have the highest deductibles and least-generous coverage, so they're the most affordable.

Employees covered by qualifying high-deductible health plans (HDHPs) — generally equivalent to Bronze plans in terms of deductibles and coverage — are eligible for tax-favored HSA contributions made by your company, the employees themselves with salary-reduction contributions, or a combination of both.

This set-up offers four key tax benefits:

1. The employer can deduct any HSA contributions made to employee accounts.

2. Employer-paid contributions are tax-free to recipient employees.

3. Employees can subtract any contributions they make from their taxable salaries, which equates to a tax deduction.

4. HSA withdrawals taken by employees to cover qualified medical expenses are tax-free.

HSAs Are a Popular Benefits Option

Americans held more than $60 billion in Health Savings Accounts (HSAs) as of June 30, 2019, according to a recent survey by HSA investment provider Devenir. That's an increase of 20% over the previous year.

There were roughly 26 million of these accounts as of June, an increase of 12% from 2018. Devenir projects that, by the end of 2021, there will be about 30 million HSAs, with assets approaching $88 billion.

In 2010, the Employee Benefit Research Institute reported that there were only 5.7 million HSAs, with account balances totaling $7.7 billion. So, HSAs are rapidly gaining ground.

An HSA is an IRA-like trust or custodial account that can be set up at a bank, insurance company or any other entity that the IRS decides is suitable (such as a brokerage firm). It is intended to be used for the purpose of paying the account owner's (employee's) qualified medical expenses. These include uninsured costs incurred by the employee, as well as his or her spouse and dependents.

In theory, HSAs can offer the same investment options as IRAs. However, some HSA trustees may limit investment choices to more-conservative options to protect these accounts from market volatility.

Qualifying Coverage

To be eligible for HSA contributions made by the employer or the employee, the employee must be covered by a qualifying HDHP and have no other general health coverage. Premiums for qualifying coverage can be paid by the company, the employee or partly by both.

For 2020, a qualifying high-deductible policy is defined as one with a deductible of at least $1,400 for self-only coverage or $2,800 for family coverage. For 2019, the minimum deductibles are $1,350 and $2,700, respectively.

For 2020, qualifying policies can have out-of-pocket maximums of up to $6,900 for self-only coverage or $13,800 for family coverage. For 2019, the out-of-pocket maximums are $6,750 and $13,500, respectively.

Important: For HSA eligibility purposes, HDHP premiums paid by an employee don't count as out-of-pocket medical costs.

Contributions

For the 2020 tax year, a tax-favored HSA contribution of up to $3,550 can be made by or for an employee who has qualifying self-only coverage, or up to $7,100 for an employee who has qualifying family coverage (anything other than self-only coverage). For 2019, the maximum contributions were $3,500 and $7,000, respectively. If an employee is age 55 or older as of year end, these amounts increase by $1,000.

HSA contributions made by an employee can be done through salary-reduction contributions to his or her company's Section 125 cafeteria benefit plan. Employer-paid contributions can be made directly to employee accounts.

Important: Eligibility for making HSA contributions doesn't depend on the employee's level of income. Everyone who's covered by a qualifying HDHP can have an HSA and enjoy the tax benefits.

Distributions

HSA distributions used to pay qualified medical expenses of the HSA owner (the employee) and his or her spouse or dependents are federal-income-tax-free. You also can build up a balance in the account if contributions, plus earnings, exceed withdrawals for medical expenses. Any earnings are federal-income-tax-free.

So, if you're in good health and take minimal or no withdrawals, you can use an HSA to build up a substantial medical expense reserve fund over the years while earning tax-free income.

If you still have an HSA balance after reaching Medicare eligibility age (generally age 65), you can drain the account for any reason without a tax penalty. If you don't use the withdrawal to cover qualified medical expenses, you'll owe federal income tax and possibly state income tax, but the 20% tax penalty that generally applies to withdrawals not used for medical expenses won't apply. And there's no tax penalty on withdrawals after disability or death.

Alternatively, you can use your HSA balance to pay uninsured medical expenses incurred after reaching Medicare eligibility age. If your HSA still has a balance when you die, your surviving spouse can take over the account tax-free and treat it as his or her own HSA — provided your surviving spouse is named as the account beneficiary. In other cases, the date-of-death HSA balance must generally be included in taxable income on that date by the person who inherits the account.

Important: HSA funds can't be used to make tax-free reimbursements for medical expenses that were incurred *before* the account was opened.

Employer-Funded Accounts

Employers can make deductible contributions to HSAs set up for their employees. Employer contributions are subject to the same dollar limits and eligibility rules as employee contributions. For 2020, the limits are $3,550 for employees with qualifying self-only coverage or $7,100 for employees with qualifying family coverage (increased by $1,000 for people age 55 or older).

Employer-paid contributions are exempt from federal income tax, as well as Social Security, Medicare and FUTA taxes. That's because these contributions are considered to be for an accident or health plan. Avoiding the employer portion of federal employment taxes is a plus for your business.

However, your company may face a 35% federal excise tax if comparable contributions aren't made on behalf of all employees with comparable coverage during the same period. For this purpose, "comparable contribution" means the same amount or the same percentage of the health plan deductible. The comparability rule is applied separately to part-time employees who customarily work less than 30 hours per week.

An exception to the comparable contribution requirement allows employers to make larger HSA contributions for non-highly compensated employees than for highly compensated employees without incurring a penalty.

Right for Your Business?

HSAs go hand in hand with more-affordable qualifying HDHPs. Plus, HSAs offer tax advantages to employers and employees. So, adding HSAs to your benefits options can be a win-win situation. Contact us for more information. We can help you fill out the requisite forms and maintain adequate records if your business decides to pursue this alternative.

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