Kick-Starting Spring with a Compliance Refresher on HSAs

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Today’s Speakers

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Please note that the following is intended to be used for general informational purposes only — it is not intended to constitute tax or legal advice. Any question regarding a specific application of a law should be addressed to legal counsel. The information is current as of March 20, 2024.
Kick-Starting Spring with a Compliance Refresher on HSAs

Agenda

Health Savings Account (HSA):

• Overview
• Eligibility
• Contributions
• Distributions
• Tax Reporting
• Compliance Takeaways
• FAQs and Compliance Nuances (throughout)
HSA Overview

HSA Basics

• NOT a group health plan, but coupled with a high-deductible health plan (HDHP)

• Employee individually-owned account (portable)

• Triple federal tax advantages

• Component of consumer-directed healthcare
  • Raises EE awareness of costs, encourages comparison shopping
  • Helps ER control expenses
• Must be paired with a **qualified** HDHP
• HSAs typically not subject to ERISA, HIPAA, COBRA, ACA.
  • e.g., ERISA plan document, Form 5500, fiduciary obligations do not apply.

• **But employer must limit involvement to prevent ERISA’s application.** Specifically:
  • Employee establishment of HSAs must be completely voluntary.
  • Employers must not:
    • limit the ability of employees to transfer their funds to another HSA
    • impose conditions on the use of HSA funds
    • make or influence HSA investment decisions
    • represent that HSAs are a group health plan
    • receive any payment or compensation in connection with an HSA

• Remember, HDHP **is** a group health plan that must comply with above laws.
• HSA program offered through a cafeteria plan is subject to Section 125 rules, including nondiscrimination rules.
HSA Overview

**Individual Ownership**

- Account terms governed by deposit agreement with HSA custodian.
- Employee owns account.
  - Sets contribution level and determines investments (if any)
  - Free to transfer funds to another custodian
  - Can maintain HSA after employment ends
- Employee ultimately responsible for:
  - Determining eligibility
  - Making contributions within limits (apply on **calendar year basis**)
  - Using funds for qualified medical expenses
  - Maintaining records for expenditures
  - Tax reporting on Form 8889 (with Form 1040) and any applicable corrections
- But employer should work with custodian to educate employees regarding their obligations!
HSA Overview

HSA Triple Federal* Tax Advantages

• Contributions
  • Pre-tax through a Section 125 cafeteria plan
    • Employee and employer contributions are not included in employee’s income or subject to payroll taxes.
  • Post-tax above-the-line deduction available for contributions outside of payroll.

• Earnings Growth
  • Interest, dividends, and capital gains not subject to federal tax
  • Potential as retirement savings vehicle

• Distributions – qualifying medical expenses not taxable

*Most states offers similar tax advantages, but there are a few exceptions. Employers and employees should verify state tax treatment with their tax advisors.
HSA Eligibility Requirements
HSA Eligibility

HSA: Eligibility Basics

• To be HSA eligible, an individual must:
  • Be covered by a qualified HDHP
  • Have no other impermissible coverage
  • Not be enrolled in Medicare
  • Not be claimed (or eligible to be claimed) as a tax dependent of another

• HSA eligibility is determined as of the first day of each calendar month.

• HSA eligibility status of a spouse or other family member is not relevant.
### HSA Eligibility

#### 2023 and 2024 Qualified HDHP Requirements

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- No benefits can be paid until the minimum statutory deductible is met, with certain exceptions, including:
  - Dental and vision expenses
  - Preventive care (e.g., periodic health exams, certain screenings, routine childcare, immunizations)
  - COVID-19 testing and treatment expenses (for plan years ending on or before December 31, 2024)
  - Telehealth services (temporary; most recent CAA 2023 relief applies to 2023 and 2024 plan years)
  - Certain insulin products
  - Benefits permitted under [IRS Notice 2019-45](https://www.irs.gov/pub/irs-pdf/n1945.pdf) (e.g., statins for heart disease) at employer's option

- IRS does not allow drug coupon or assistance to apply to the cost-sharing limit.
  - But state laws may impact treatment by insured plans.
  - After 2023 DC district court ruling, the application of drug coupons is unclear; ER should consult with counsel.
HSA Eligibility

Impermissible Coverage

- Any coverage providing non-exception benefits before the HDHP statutory deductible is met, including:
  - Medicare Parts A, B, C, or D entitlement (i.e., enrollment – not just eligibility)
    - Beware: Part A coverage may be retroactive up to 6 months, impacting eligibility.
  - Medicaid
  - TRICARE
  - Receipt of VA medical benefits during the preceding 3 months
    - Unless preventive care services or medical/hospital care “for a service-connected disability”
    - VA medical or hospital care received by a veteran with a disability rating from the VA may be disregarded.
HSA Eligibility Requirements

Impermissible Coverage (continued)

- General purpose HRA or health FSA
  - includes coverage through spouse
  - Grace period or carryover provisions may extend ineligibility period
  - Post-deductible or limited purpose HRA or FSA is allowed (covers only vision or dental or only pays after minimum deductible is met)

- On-site medical clinic, EAP providing “significant” medical benefits or point solution program
  - Facts and circumstances analysis applies

- Be careful with hospital indemnity policies!
  - Fixed amount payout per day or period of hospitalization is generally permissible.
  - Coverage that is service-based or provides significant other benefits (e.g., ambulance coverage) may not be.

- Employers should review their other benefit offerings carefully for HSA compatibility!
Effect of FSA Grace Period or Carryover on HSA Eligibility

- **Grace Period** – extends FSA plan year by up to 2.5 months to allow EEs more time to incur claims.
  - HSA eligibility is determined on the 1st of the month.
  - With a grace period, generally, participant is not HSA eligible until the 1st of the month after grace period ends unless they have a zero balance at plan year end.
  - E.g., Roger’s 2023 calendar year FSA has a 2.5-month grace period.
    - He would not be eligible to contribute to an HSA until 4/1/2024.
    - But if Roger had a zero FSA balance on 12/31/2023, he would be HSA eligible on 1/1/2024.
    - Alternatively, employer could elect mandatory conversion of FSA to limited purpose or post-deductible FSA for all participants.

- **Carryover** - allows indexed amount equal to 20% of salary deferral limit ($640 for 2024) to be carried over from one plan year to the next.
  - FSA carryover will generally prevent HSA eligibility for the entire following plan year.
  - So, if Roger’s plan has a carryover instead of a grace period, he would not HSA eligible until 1/1/2025.
  - But a health FSA plan could be designed to:
    - Allow or require carryover balance to a limited purpose FSA for EEs electing an HSA/HDHP
    - Allow EEs to waive (forfeit) carryover balance to allow them to contribute to an HSA
    - Employers that introduce HDHP/HSA midyear must recognize the interaction of existing health FSA coverage with the new offering.

- **Offering an HSA is not a qualifying event that allows FSA participants to drop coverage!**
FAQ: Impact of Spouse/Dependent HSA Eligibility

• Is HSA eligibility impacted if the employee’s spouse is enrolled in Medicare (or other impermissible coverage)?
  • No; only the employee’s own coverage matters.
  • If a spouse (or child) has other coverage, the employee is still eligible for the HSA.
    • Unless the employee is also covered under the spouse’s impermissible coverage – e.g., health FSA.
  • The contribution limit is still based on the tier (e.g., single, family) of coverage.
HSA Eligibility

FAQ: Midyear HDHP/HSA Offering

• The employer sponsors a health FSA and is adding an HDHP/HSA mid-year. What are the considerations?

  • The employees participating in the health FSA will not be eligible for the HSA until the end of the FSA plan year (or grace period, if applicable).

    ▪ The addition of the HSA and HDHP is not a qualifying event permitting *individual* employees to change their FSA election.

    ▪ The employer could choose to make changes to the *entire* FSA to allow employees to access the HSA.

      • But this may not be advisable if participants were not made aware of the upcoming changes prior to enrollment.

      • Client should review with counsel.
FAQ: Telehealth Services

- Do telehealth services adversely impact HSA contribution eligibility?

- Generally, telehealth services could negatively impact HSA eligibility if providing non-allowed medical benefits before the HDHP deductible is met.

- However, under the CARES Act, CAA 2022, and currently, the CAA 2023, a participant can maintain HSA eligibility even if first-dollar coverage of telehealth services is provided.
  
  - CAA 2023 relief applies to plan years beginning after December 31, 2022, and before January 1, 2025.
  
  - Will end December 31, 2024, for calendar year plan unless relief is extended again or made permanent.
FAQ: Employer Obligations

• What are the employer’s obligations to verify an employee’s HSA eligibility?

• ER is responsible for determining:
  • EE is covered by an HDHP and has no disqualifying coverage sponsored by the ER
  • EE’s age (for catch-up contribution eligibility)
  • EE has all other responsibility

• ER should monitor benefit offerings for HSA compatibility.

• ER should work with HSA vendor to educate EEs regarding eligibility requirements.
  • Not required but will benefit all and help to avoid excess contributions.
HSA Contribution Rules
HSA Contribution Rules

HSA Annual Maximum Contribution Limits

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<th>Tier</th>
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- Two levels of coverage: Single ("self-only") and Family ("non-self only")
- Limits apply on a calendar year basis regardless of HDHP plan year
- Those age 55 or older are eligible for an additional $1,000 “catch-up” contribution
- Limit includes all contributions to the HSA (e.g., employer and employee)
- Deadline for contributions is Tax Day of following year (e.g., April 15, 2024)
Annual Contribution Limit Subject to Pro-Ration

• HSA “eligibility” is measured as of the first of each month.

• Example: Larry enrolls in self-only HDHP coverage which begins on January 1, 2024. and then enrolls in Medicare when he reaches age 65 with that coverage beginning on July 1, 2024. Both Larry’s self-only HDHP coverage and his Medicare coverage continue through the end of 2024.

• Larry was HSA eligible for 6/12 (1/2) of the 2024 calendar year.
  • So, the maximum 2024 HSA contribution is 1/2 of $4,150 or $2,075
  • The catch-up would also be pro-rated to 1/2 of $1,000 or $500
  • So, Larry could contribute $2,075 + $500 or $2,575 for 2024. Larry has until April 15, 2025, to make the contribution for 2024.

• If Larry failed to prorate the maximum and contributed $4,850, Larry would need to remove the excess $2,275 prior to the tax filing deadline for 2024. Otherwise, Larry will owe a 6% excise tax on the excess amounts.
Alternative: “Full Contribution” (aka “Last Month”) Rule

• Employee can make the full contribution (up to the annual limit) even if not HSA-eligible for the entire year, provided that:
  • The employee is HSA-eligible on December 1 of the year, and
  • The employee remains HSA-eligible for the entire following year (i.e., termed the 13 month “testing period”)

• Example: Cheryl enrolls her family in HDHP coverage on November 1, 2024, and makes the full family contribution ($8,300) to her HSA for 2024.
  • All's well if Cheryl remains HSA-eligible through December 31, 2025.
  • If Cheryl fails to remain HSA-eligible through the end of 2025, her 2024 contribution would be pro-rated to 2/12 (or 1/6) of $8,300 or $1,383.33 and she would be subject to income taxes and an additional 10% penalty tax on $6,916.67 (i.e., the difference between her contribution and the permitted pro-rated monthly amount).

  If Cheryl is 55 or older she would also need to pro-rate the $1,000 catch-up contribution.
Employer Contribution Rules

- Contributions to HSAs are optional for employers.
- They do count toward the applicable maximum limit and are generally non-forfeitable.
- Can be “front-loaded” early in year to benefit employees
  - If the EE terminates employment or the HDHP coverage midyear, the ER cannot recoup the funds.
  - Whether front-loaded or periodic (“as-you-go”) is up to employer
- Restrictive comparability rules generally require comparable employer contributions to be made to employees in the same category (full-time, part-time, and former employees) and coverage tier
  - These rules apply to employer contributions unless contributions can be made through a Section 125 cafeteria plan.
  - So: Most ERs prefer the cafeteria plan option
    - EEs must be permitted to change contribution amounts at least monthly
    - The pre-tax contributions are subject to the Section 125 nondiscrimination rules, which prohibit discrimination in favor of highly compensated employees (HCEs)
Nondiscrimination Rules

- Most ERs permit pre-tax HSA contributions to be made through a Section 125 cafeteria plan.
  - EEs must be permitted to change contribution amounts at least monthly.
- The pre-tax contributions are subject to the Section 125 nondiscrimination rules, which prohibit discrimination in favor of highly compensated employees (HCEs).
  - For 2024, an HCE is any officer, a more-than-5% shareholder/owner, or any individual with compensation in excess of $150,000 in 2023.
  - The Section 125 tests review eligibility (who may participate), contributions and benefits (the benefits available to participants), and utilization (who is actually benefiting).
  - Employers can vary contributions between bona fide classifications of employees (e.g., by location, occupation, hire date), provided the result does not favor HCEs.
  - Testing early in the year is always advisable, so any potential testing issues can be addressed.
    - Test failures result in HCEs losing the Section 125 tax advantages.
FAQ: Midyear Coverage Changes

- How are contributions impacted if employee's tier of coverage changes midyear?
  - Under the full contribution rule, they can contribute the greater of:
    - The full amount based on tier of coverage on December 1\textsuperscript{st}; or
    - The total of monthly contributions based on coverage tier
  - Leon has single coverage effective January 1, 2024. He gets married and adds his spouse to his HDHP on August 15, 2024.
    - Monthly total: He had single coverage for 8 months ($2,766.67) and family coverage for 4 months ($2,766.67) for a total contribution of $5,533.34, or
    - Full contribution: $8,300 for 2024
FAQ: Excess Contribution Correction

• What should be done if an individual contributes to their HSA in excess of the maximum limit?
  • Individual will need to take corrective action to remove excess
  • Excess contributions must be included in gross income and may be subject to 6% excise tax, if not timely removed
    • Generally, to avoid the tax, removal must be done by April 15th after the end of the tax year of the error
  • Tax Issue: Always advisable to consult with a tax professional
FAQ: Can an employer recoup a mistaken HSA contribution?

• General Rule: Employer HSA contributions are non-forfeitable
  • Limited Exceptions
    ➢ Individual was never HSA-eligible
    ➢ Excess contributions
    ➢ Clear and convincing evidence of administrative or process error
  • Any such recoupment must be made by the end of the tax year (e.g., by December 31, 2024, for 2024).
  • Possible HSA custodian issues
HSA Distributions
Basic HSA Distribution Rules

• HSAs are also designed to reimburse participants for expenses incurred for medical care for the HSA owner and the owner’s spouse and tax dependents as defined in Code §213()(2).
  • Tax dependent generally refers to children under age 19 or under age 24 and a full-time student
  • NOTE: HSA rules do not incorporate the ACA age 26 rule.

• IRS Publication 502 describes “qualified” medical expenses.
  10 Includes pre-deductible medical and drug expenses, co-payments, dental, and vision costs.
  10 OTC without Rx (after January 1, 2020)
  10 SOME insurance premiums/coverage are eligible.
  • COBRA or USERRA continuation coverage, maintenance of health plan while receiving unemployment, and health insurance (other than Medicare supplemental) if 65 or over

• Long-term care insurance (subject to eligible premium (age-related) limits)
HSA Distribution Timing Issues

• Establishment Rule: A qualified medical expense must be incurred after the HSA is “established”.
• Establishment is based upon state trust law, which typically requires that a trust be funded.
  • So, HSA may not be established until funds are deposited.
    ▪ E.g., Susie enrolls in an HDHP for 2024 and elects to make semi-monthly HSA payroll contributions. She completes the paperwork with the HSA custodian in December 2023. Her first payroll contribution occurs on January 15, 2024.
    ▪ Susie’s HSA is established on January 15, 2024. Expenses occurred prior to this date are not eligible for tax-free distribution.
• Exception may apply if individual had a prior HSA. If the prior HSA had a positive balance at any time during the 18-month period preceding the new HSA’s establishment, then the new HSA is deemed established when the prior HSA was established.
  ▪ E.g., Susie had an HSA with a prior employer that was established on March 17, 2022; the last funds in this account were distributed in July 2023.
  ▪ Susie’s new HSA is deemed established on March 17, 2022, and any qualified medical expenses incurred from this date are eligible for tax-free reimbursement.
HSA Distribution Timing Issues (Continued)

- “Shoe Box” rule:
  - HSA distributions for a medical expense can be made at any future time.
  - Recordkeeping must demonstrate:
    - Expense was a qualified medical expense
    - Not previously reimbursed by any other source
    - Was not taken as an itemized deduction in any prior taxable year

- Can take a distribution for medical expenses incurred even after HSA accountholder is no longer eligible for further contributions
Tax Treatment of HSA Distributions

• From a tax perspective, there are three basic kinds of HSA distributions:
  - **Free and Clear**: Distributions for qualified medical expenses at any age
  - **Taxable**: Distributions for non-qualified medical expenses after the account holder has reached age 65 or is disabled are taxable as income
  - **Taxable and Penalized**: Any other distribution is taxable as income and subject to a 20% excise tax

• Special Situations:
  - Rollovers, Trustee-to-Trustee Transfers, and Transfers to Spouse via divorce decree: Nontaxable
  - Death of Account holder:
    - If beneficiary is surviving spouse: Remains an HSA/Nontaxable
    - If beneficiary is someone else: No more HSA/Taxable to beneficiary
FAQ: Taxation of Nonqualified Expenses

• What happens if the employee uses HSA funds to pay for a nonqualified expense?
  • The distribution is included in the account holder’s gross income and is subject to an additional 20% penalty tax
    ▪ Not applicable if the mistaken distribution is returned to the HSA no later than April 15th following the year in which the mistake was known
  • Reported on Form 8889 (Health Savings Accounts) with Form 1040
  • The 20% penalty tax does not apply to nonqualified distributions:
    ▪ Following the account holder’s death
    ▪ After the account holder is aged 65
    ▪ After the account holder becomes disabled
HSA Tax Reporting
HSA Tax Reporting

• **Employer Reporting Obligations:**
  - HSA contributions made through a cafeteria plan are reported in Box 12 of Form W-2 with code W.

• **HSA Custodian Reporting Obligations:**
  - The HSA custodian reports all contributions to the account for the year on Form 5498-SA, which is filed with the IRS and sent to the account holder by May 31 of the following year.
  - The custodian also reports all distributions from the account in the year on Form 1099-SA, which is provided to the account holder by January 31 of the following year.

• **Account Holder Reporting Obligations:**
  - All individuals who had HSA contributions or distributions must report the activity on Form 8889, which is included with the individual tax return (Form 1040).
  - Form 5329 may also be required to report any excess contributions and earnings.
HSA Compliance Takeaways

• HSAs can lower health plan costs for employers and provide significant federal tax savings for employers and employees.

• Employers should plan proactively when implementing HSAs for the first time. Midyear introduction is generally not advisable.

• Coordination with the HSA custodian/vendor is important to ensure account set up process and employee communications are clear.

• Employees are responsible for compliance with eligibility, contribution and distribution rules, and may need education on the requirements.

• BUT employers offering HSAs through a cafeteria plan must verify the employees are covered by an HDHP and do not have other impermissible coverage (e.g., health FSA) with the employer.

• Employers should consider funding any employer contributions throughout the year rather than in a lump sum and have a written contribution policy.

• Employers should be aware of the Section 125 nondiscrimination rules and the advantages of midyear testing to prevent test failures.

• Please review our comprehensive HSA employer guide and toolkit for further details. If you would like a copy, please contact your broker or consultant.
Thanks for joining us today. Please let us know if you have any questions.