

# How HSAs help employees and employers reduce taxes

## A case study

**George W. Schein, JD**  
Director, Advanced Consulting Group

### HSA — Basic Background

A health savings account (usually referred to as an “HSA”) is a tax-exempt trust or custodial account set up with a qualified HSA trustee to pay or reimburse *qualified medical expenses*.<sup>1</sup> Qualified medical expenses include many things, but predominantly are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and for the purpose of affecting any part or function of the body.<sup>2</sup> Transportation costs primarily for, and essential to, medical care also may qualify as medical expenses, as do amounts paid for qualified long-term care services, and limited amounts paid for qualified long-term care insurance contracts.<sup>3</sup> Many medical, prescription drug, dental, and vision related expenses are safely considered to be qualified medical expenses. However, note that these medical expenses must be primarily to alleviate or prevent a physical or mental disability or illness to be qualified; expenses that benefit health in general, such as the cost of supplements or vacations, are not considered qualified medical expenses.<sup>4</sup>

In order to be eligible to contribute to an HSA (*i.e.*, to be “HSA-eligible”), an individual must (1) be covered under a high deductible health plan (an “HDHP”), (2) have no other disqualifying coverage, (3) **not** be enrolled in Medicare, and (4) **not** be claimed as a dependent on someone else’s tax return.<sup>5</sup> Eligibility to contribute to an HSA is determined on a monthly basis.<sup>6</sup>

So long as money contributed to the HSA (up to an annually adjusted limit) of an HSA-eligible individual is

used to pay for qualified medical expenses, the amount contributed will avoid various forms of taxation. With this general background information in mind, let’s take a look at a case study that shows just how HSAs can help employees, and their employers, reduce their tax liability.

### A case study — The Good Company, Inc.

The Good Company, Inc. (the “GC, Inc.”) is located in Columbus, Ohio. The GC, Inc. has over 50 full-time employees and due to rapidly increasing healthcare costs, switched from a more traditional group health plan to a HDHP starting in 2019. Of those 50 full-time employees, 10 employees enroll in single coverage and 20 employees enroll in family coverage under the HDHP. In connection with enrollment in the HDHP, the GC, Inc. worked with Nationwide to help its HSA-eligible employees set up their own individual HSAs to save money on a tax-free basis to cover their qualified medical expenses.

In addition to facilitating pre-tax employee contributions to the individual HSAs of its HSA-eligible employees through its Code Section 125 cafeteria plan, the GC, Inc. also makes an annual \$500 employer contribution to the HSAs of those HSA-eligible employees enrolled in the single HDHP and an annual \$1,000 employer contribution to the HSAs of those HSA-eligible employees enrolled in the family HDHP.

The following examples illustrate the possible tax savings for individual GC, Inc. employees, as well as GC, Inc. generally, that is achieved by adding HSAs as an employee benefit.

**Example 1 – Employee Adam’s Tax Savings**

Adam is 30 years old and lives in Columbus, OH. He earns an annual gross salary of \$52,000, paid biweekly. He is single, healthy, and uses most of his salary to cover living expenses. Adam is HSA-eligible and decides to contribute \$100 per paycheck into his HSA for future medical expenses.

	Pay Period	Annual
Gross Salary	\$2,000.00	\$52,000.00
HSA Employee Contribution	\$100.00	\$2,600.00
<b>Tax Savings</b>		
Federal Tax (22%)	\$22.00	\$572.00
State Tax (3.46%)	\$3.46	\$89.86
FICA Tax (7.65%)	\$7.65	\$198.90
<b>Total Tax Savings</b>	<b>\$33.11</b>	<b>\$860.86</b>

When combining Adam’s pre-tax contributions (\$2,600) to his HSA with the GC, Inc.’s \$500 employer contribution, Adam was able to save \$3,100 in his HSA in 2019. As long as the money is used to pay for qualified medical expenses, Adam will save \$860.86 in the form of reduced federal, state, and FICA taxes.

**Example 2 – Employee Ruth’s Tax Savings**

Ruth is 60 years old and lives in Columbus, OH. She earns an annual gross salary of \$104,000, paid biweekly. She and her spouse have their house paid off and their kids through college. Recognizing that rising healthcare costs will impact her family’s retirement income, Ruth decides to maximize her annual contributions to her HSA to cover future medical expenses. Because the GC, Inc. already contributes \$1,000 to her HSA, and because she has family HDHP coverage, Ruth contributes \$6,000 (the total maximum amount permitted to be contributed to an HSA, by an employee and employer combined, for family coverage in 2019 is \$7,000), plus an additional \$1,000 “catch-up” contribution she may make because she is over age 55.

	Pay Period	Annual
Paycheck	\$4,000.00	\$104,000.00
HSA Employee Contribution	\$269.23	\$7,000.00
<b>Tax Savings</b>		
Federal Tax (22%)	\$59.23	\$1,540.00
State Tax (3.96%)	\$10.66	\$277.20
FICA Tax (7.65%)	\$20.60	\$535.50
<b>Total Tax Savings</b>	<b>\$90.49</b>	<b>\$2,352.70</b>

When combining Ruth’s total pre-tax contributions (\$7,000) to her HSA with the GC, Inc.’s \$1,000 employer contribution, Ruth was able to save \$8,000 in her HSA in 2019. As long as the money is used to pay for qualified medical expenses, Ruth will save \$2,352.70 in the form of reduced federal, state, and FICA taxes.

**Example 3 – The Good Company, Inc.’s Tax Savings on Employee Contributions**

In addition to its employees’ tax savings, the GC, Inc. reduces its own FICA tax obligation by facilitating the pre-tax employee contributions to the HSAs of its HSA-eligible employees (like Adam and Ruth) through its Code Section 125 cafeteria plan. On a company-wide basis, let’s say of the GC, Inc.’s 10 employees who elect single HDHP coverage, the average annual pre-tax employee contribution to their respective HSAs is \$1,000, and of the 20 GC, Inc. employees who elect family HDHP coverage, the average annual pre-tax employee contribution to their respective HSAs is \$2,000.

	Employee Contribution	FICA Tax (7.65%)
Employees w/ single coverage (\$1,000 x 10)	\$10,000.00	\$765.00
Employees w/ family coverage (\$2,000 x 20)	\$40,000.00	\$3,060.00
<b>Total</b>	<b>\$50,000.00</b>	<b>\$3,825.00</b>

By facilitating employee contributions through its Code Section 125 cafeteria plan, the GC, Inc. saved itself \$3,825 in the form of reduced FICA taxes. This amount does **not** include the additional amount saved by the employer contribution that the GC, Inc. makes on behalf of its HSA-eligible employees, as shown in the final example.

#### Example 4 – The Good Company, Inc.’s Tax Savings on Employer Contributions

Because the GC, Inc. saved money by switching from the more traditional group health plan to the HDHP, it decides to pass that savings along to employees. However, instead of passing the savings along as additional taxable compensation to its employees, the GC, Inc. decides to make employer contributions into the HSAs of its HSA-eligible employees (\$500 to each of those 10 employees with single HDHP coverage and \$1,000 to each of those 20 employees with family HDHP coverage). These employer contributions are not only tax free to the employees (so long as they are used for qualified medical expenses), but GC, Inc. will also reduce its own federal corporate tax and FICA tax burden.

	Individual (x10)	Family (x20)	Annual
Employer contribution	\$5,000.00	\$20,000.00	\$25,000.00
<b>Tax Savings</b>			
Federal Tax (21%)	\$1,050.00	\$4,200.00	\$5,250.00
State Tax (0%)	\$0.00	\$0.00	\$0.00
FICA Tax (7.65%)	\$382.50	\$1,530.00	\$1,912.50
<b>Total Tax Savings</b>	<b>\$1,432.50</b>	<b>\$5,730.00</b>	<b>\$7,162.50</b>

By contributing \$25,000 to the HSAs of its HSA-eligible employees, the GC, Inc. saved \$7,162.50 in the form of reduced corporate and FICA taxes. Put another way, the \$25,000 employer contribution costs the GC, Inc. only \$17,837.50.

## Conclusion

As these examples in our case study of the Good Company, Inc. reflect, incorporating HSAs to help its employees save money for qualified medical expenses is a win for both employees and employer. HSAs help employees cover the cost of medical care while helping to shield their income from taxation, and also help employers reduce their own tax obligations.



<sup>1</sup> IRS Publication 969 (2017).

<sup>2</sup> I.R.C. 213(d)(1).

<sup>3</sup> Id.

<sup>4</sup> IRS Publication 502 (2018).

<sup>5</sup> I.R.C. 223.

<sup>6</sup> Id.

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