COMPLIANCE ALERT

Correcting Excess HSA Contributions

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Quick Facts

- The Internal Revenue Service (IRS) sets the maximum annual health savings account (HSA) contribution each year.
- Contributing more than an individual HSA account holder is eligible for is known as an excess HSA contribution and must be corrected to avoid taxes and penalties.
- There are two primary ways to correct an excess HSA contribution.

Background

The IRS sets the maximum annual HSA contribution each year. Contributing more than an individual HSA account holder is eligible for is known as an excess HSA contribution and is subject to both income tax and a 6% excise tax each year until corrected. Excess contributions can occur for several reasons such as:

- Failing to account for HSA contributions made by an employer or another individual. All contributions made by the HSA account holder, an employer, or by any other individual (such as a spouse) count toward the annual contribution limit.
- Failing to account for being HSA-eligible for only a portion of the year. HSA eligibility is determined monthly, and an individual may generally contribute 1/12 of the annual limit for each month of HSA eligibility. Individuals who are HSA-eligible for only a portion of the year can generally contribute only a pro-rata portion of the annual contribution limit.
- Administrative error. Mistakes in payroll deduction amounts, incorrect tracking in a benefits administration system, or delays in transfers of contributions to the HSA vendor may result in excess contributions.

How are Excess HSA Contributions Corrected?

There are two primary ways to correct an excess HSA contribution. The first is to remove the excess funds before the tax deadline in the same year they were made. The second is to apply your excess contributions towards next year's annual contribution.

Option 1: Removing Excess Funds in the Same Year They Were Made

Withdraw the excess contribution(s) through a curative distribution by the tax filing deadline of the year the contribution was made (April 15), and withdraw any income earned (also referred to as attributable earnings) on the excess contribution(s) and including it on your tax return for that year.

When including attributable income on your current year tax return, pre-tax contributions, (the earnings and the contribution) should be included in the employee's gross income on the individual tax return. Post-tax contributions (the earnings attributable to the excess contribution) would be taxable as income for the year in which the distribution is made, but the removed excess contribution would not be taxable as income.

Example: Calculating Attributable Earnings

Net income = Excess Contribution × (Adjusted Closing Balance − Adjusted Opening Balance) ÷ Adjusted Opening Balance)

- The Adjusted Opening Balance is the sum of the excess contribution and the balance immediately before that excess contribution was made (i.e., the balance at the start of the computation period).
- The Adjusted Closing Balance is the balance immediately prior to the distribution of the excess contribution (i.e., the balance at the end of the computation period), plus any distributions or transfers made in the interim (i.e., during the computation period).

An HSA account holder with excess contributions should contact their HSA trustee or custodian to request a curative distribution of the excess contributions. The trustee/custodian will report the distribution on Form 1099-SA, coded as an excess contribution. The total distribution (excess and attributable earnings) is reported in Box 1, Gross distribution, on Form 1099-SA and only the attributable earnings are reported in Box 2, Earnings on the excess contribution. To indicate that the distribution is the removal of an excess contribution, code 2, Excess contributions, must be entered in Box 3. The Form 1099-SA instructions indicate that HSA owners must include the attributable earnings distributed with the excess as income for the year the distribution is received. If insufficient funds remain in the individual's HSA to accomplish the distribution due to prior distributions, the account holder can ask the trustee/custodian to report earlier distributions including a distribution of the excess contribution, plus earnings. The employer should include the excess contributions as the employee's wages on the W-2. If that doesn't happen, the HSA account holder should report this amount as "other income" on their federal income tax return.

The HSA custodian (vendor) will likely help with determining the attributable earnings. The formula for calculating net income (i.e., earnings) attributable to excess contributions is the same formula established for individual retirement accounts (IRAs) under Treas. Reg. §1.408-11.

Option 2: Current-Year Deduction for Undistributed Excess Contributions from Previous Year.

The Instructions for Form 8889 state that an HSA-eligible individual may be able to deduct excess contributions for previous years that remain in the individual's HSA. The current-year deduction is limited to the lesser of:

1. The individual's maximum HSA contribution limit for the current year, minus any amounts contributed to his or her HSA for that year; or
2. The total excess contributions in the individual's HSA at the beginning of the current year. Any excess contributions remaining in the individual's HSA at the end of the taxable year (i.e., the undistributed excess contributions) would be subject to the 6% excise tax on excess contributions.

This option is a bit more complicated, especially if there are earnings from any of the excess contributions, and requires the use of Form 5329 to report the deduction. It is recommended to consult with your HSA administrator and tax advisor.

Example: Current-Year Deduction for Undistributed Excess Contributions from Previous Year

HSA-eligible individual, Beth, age 45, had self-only high deductible health plan (HDHP) coverage for all of 2021. The maximum HSA contributions that could be made to Beth's HSA for 2021 was $3,600. Beth unintentionally contributed $4,600 to her HSA for 2021, resulting in a $1,000 excess contribution, which remains in her HSA. Beth also had self-only HDHP coverage for all of 2022 and the maximum amount that could be contributed to her HSA for 2022 was $3,650. However, Beth only contributed $2,700 to her HSA for 2022. So, for the 2022 taxable year, Beth may deduct $900 of the prior year's excess contribution, which is the lesser of (1) $900 (i.e., the difference between the $3,600 contribution limit for 2021 and her $2,700 contribution for 2022); or (2) the $1,000 excess contributions remaining in her HSA at the beginning of 2022. Beth would report this deduction on Form 8889 for 2022.

Summary

It is important for HSA participants to keep careful track of their contributions throughout the year. Excess HSA contributions should be corrected as soon as possible after discovery or participants risk taxes and penalties.

EPIC Employee Benefits Compliance Services

For further information on this or any other topic, please contact your EPIC benefits consulting team.