PENNSYLVANIA DEPARTMENT OF REVENUE

PERSONAL INCOME TAX BULLETIN 2006-6
HEALTH SAVINGS ACCOUNTS
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Personal Income Tax Bulletin 2006-6

Health Savings Accounts

§ 1. Overview.

Act 2006-67 provides that substantially all the requirements of Section 220 of the Internal Revenue Code (IRC) are applicable for Pennsylvania Personal Income Tax purposes.[1] Consequently, for tax years beginning after December 31, 2005, the taxation of Health Savings Accounts (HSAs) will follow the federal rules. Section 223 of the IRC outlines the taxability of HSAs on the federal level.

The key attributes of an HSA include the following:

- Individuals with high deductible health insurance may make pre-tax contributions to an HSA.
- Amounts paid or distributed out of an HSA that are used exclusively to pay the qualified medical expenses of the account beneficiary are not subject to tax.
- Amounts paid or distributed out of an HSA that are not used to pay qualified medical expenses are includible in income and are subject to tax.
- Excess contributions to an HSA are subject to tax.
- HSAs are exempt from taxation.

This bulletin will explain the Pennsylvania Personal Income Tax treatment of an HSA for taxable years beginning after December 31, 2005, using the following outline:

[1] Act 2006-67 added the following provision to Article III of the Tax Reform Code:

> Except as provided in this Article and without regard to Sections 220(f)(4) and 223(f)(4) of the Internal Revenue Code of 1986, the requirements of Sections 106(b) and (d), 220 and 223 of the Internal Revenue Code of 1986, as amended to January 1, 2005, shall be applicable.

72 P.S. 7303(a.6).

§ 2. Definitions.

When used in this bulletin, the following words and phrases shall have the meanings given to them in this section:

"Account beneficiary." The term "account beneficiary" means the individual on whose behalf the HSA was established.

"Eligible individual." An individual qualifies as an "eligible individual" with respect to any month if the individual –

A. is covered under a high deductible health plan as of the 1st day of such month,
B. is not entitled to Medicare benefits,
C. has no other health care coverage except as described in "other health coverage," and
D. cannot be claimed as a dependent on another taxpayer's federal tax return.

"Health savings account (HSA)." A trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary provided the written governing instrument creating it contains the following requirements:

A. Contributions must be in cash.

B. No contribution will be accepted to the extent such contribution when added to previous contributions made for the calendar year exceeds the annual deductible of the high deductible health plan plus the additional contribution allowed if the "eligible individual" has attained age 55 before the close of the tax year unless the contribution is a permitted rollover contribution.

C. The trustee is a bank or another entity or person acceptable to the Secretary of the Treasury.

D. The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.

E. The trust assets will not be invested in life insurance contracts.

F. The individual interest in the balance in the account is nonforfeitable.

"High deductible health plan" (HDHP). An HDHP has a higher annual deductible than a typical health plan. It also has a maximum limit on the sum of the annual deductible and out of pocket medical expenses that an individual must pay for covered expenses. Out-of- pocket expenses include co-payments and other expenses but do not include premiums. An HDHP with family coverage may have deductibles for both the family as a whole (the umbrella deductible) and for individual family members (the embedded deductible).

- In 2006, federal law requires that the plan's deductible be at least:

  $1,050[*] - self-only coverage
  $2,100[*] - family coverage

  An HDHP can provide "preventive care" services with no deductible or a deductible below the minimum annual deductible. Preventive care includes routine pre-natal and well-child care, child and adult immunizations, annual physicals, mammograms, pap smears, etc.

- The maximum annual deductible and other out-of-pocket expenses required to be paid for covered benefits cannot exceed:

[*] Each year this dollar amount changes as a result of the required annual cost-of–living adjustment.

$5,450* - self-only coverage
$10,500* - family coverage

A network health plan shall not fail to be treated as an HDHP by reason of having an out-of-pocket limitation for services provided outside of a network of providers.

- A family plan will not qualify as an HDHP if either the umbrella deductible or the embedded deductible is less than the minimum annual deductible for family coverage ($2,100*).

- A family plan with no umbrella deductible will not qualify as an HDHP when the deductible for each family member multiplied by the number of family members exceeds the maximum annual deductible and other out- of-pocket expenses for family coverage ($10,500*).

- A plan is not an HDHP if substantially all of the coverage it provides is for accidents, disability, dental care, vision care, or long-term care.

“Internal Revenue Code.” The Internal Revenue Code of 1986 as amended to January 1, 2005.

“Other health coverage.” An eligible individual’s health care coverage is limited to an HDHP except for the following:

A. Insurance which provides benefits only for –
   1. Liabilities incurred under workers’ compensation laws, tort liabilities, or liabilities related to ownership or use of property.
   2. A specific disease or illness.
   3. A fixed amount per day (or other period) of hospitalization.

B. Coverage (whether provided through insurance or otherwise) for the following items:
   1. Accidents
   2. Disability
   3. Vision care
   4. Dental care
   5. Long-term care.

C. A prescription drug plan if the plan does not provide benefits until the minimum annual deductible of the HDHP has been met.

"Qualified medical expenses." Expenses other than most insurance premiums that qualify for the federal medical and dental expenses deduction. Such expenses could be taken on a federal Schedule A by the HSA account beneficiary if they were not paid for by an HSA distribution. Examples include amounts paid for doctors' fees, prescription and non-prescription medicines, and necessary hospital services not paid for by insurance. Section 213 of the IRC describes qualifying expenses. "Qualified medical expenses" do not include amounts paid for medical insurance premiums except for –

A. Qualified long-term care insurance,
B. Medicare premiums and coinsurance for Part A, Part B, Part C and Part D coverage but not a Medicare supplemental policy,
C. COBRA continuation coverage after leaving employment with a company that offers health insurance coverage,
D. Health plan coverage while receiving federal or state unemployment benefits.

§ 3. HSA contributions/deductions.

For an HSA held by an employee, the employee and the employer may contribute. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Beginning with the first month that an individual is eligible for Medicare benefits, the individual can not contribute to an HSA. Contributions of stock or property are not permitted.

A taxpayer who has a self-only HDHP for the entire year can contribute up to the amount of the annual health plan deductible, but not more than $2,700. If the taxpayer has family coverage for the year, the taxpayer can contribute up to the amount of the annual heath plan deductible, but not more than $5,450.

If a taxpayer has an HDHP for a period less than a year, the taxpayer's allowable deduction is calculated by determining the annual deductible on a monthly basis and totaling this amount for each month that the taxpayer was covered by the HDHP.

> **Example 1.** On July 1, 2006, H acquires an HDHP for his family with an annual deductible of $4,000. H's contribution limit is $2,000 ($4,000 x 6/12).

For 2006, if an eligible individual is age 55 or older, the contribution limits listed above are increased by $700[2]; therefore, if an individual has self-only coverage, the individual can

[2] For tax years after 2006, the additional contribution amount equals: $800 in 2007; $900 in 2008, and $1,000 in 2009 and subsequent years.

contribute up to the amount of the HDHP's annual deductible plus $700, but not more than $3,400. Similarly, if an individual has family coverage, the allowable contribution amount increases to $6,150.

> **Example 2.** On July 1, 2006, H acquires an HDHP for his family with an annual deductible of $4,000, and on September 3 H reaches age 55. H's contribution limit is $2,350 ([$4,000 + 700] x 6/12).

A family HDHP may have deductibles for both the family as a whole (the umbrella deductible) and for individual family members (the embedded deductible). The contribution limit for this type of HDHP is the least of the following amounts:

A. The maximum annual contribution limit for family coverage ($5,450 for 2006),
B. The umbrella deductible, or
C. The embedded deductible multiplied by the number of family members covered by the plan.

> **Example 3.** For 2006, H has a family HDHP which covers himself, his spouse, and their two children. The HDHP will pay benefits for a family member whose covered expenses exceed $2,000 (the embedded deductible) and will pay benefits for all family members after the family's covered expenses exceed $5,000 (the umbrella deductible). The maximum annual contribution limit is $5,000 (the least of $5,450, $5,000, or $8,000 ($2,000 x 4)).

§ 4. Reporting HSA contributions.

An employer does not include employer contributions in "state wages" on the employee's W-2 and does not withhold on these monies.

Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer. The contributions are treated as a distribution of money and are not included in the partner's gross income. Contributions by a partnership to a partner's HSA for services rendered are treated as guaranteed payments that are deductible by the partnership and includible in the partner's gross income. In both situations, the partner can deduct the contribution made to the partner's HSA.

Contributions by an S corporation to a two (2%) percent shareholder-employee's HSA for services rendered are treated as guaranteed payments and are deductible by the S corporation and includible in the shareholder-employee's gross income. The shareholder-employee can deduct the contribution made to the shareholder-employee's HSA.

§ 5. Reduction of contribution limit.

An individual's allowable HSA contribution is reduced by the amount of any contributions the individual or his employer makes to an Archer MSA.

> **Example.** In 2006, H who is age 40 has a self-only HDHP with an annual deductible of $1,200. H's employer makes a $1,000 contribution to H's Archer MSA. H's contribution limit on his HSA is $200 ($1,200 - 1,000). If H contributes $200 to his HSA, the deduction H would list on his PA-40 is $200.

§ 6. Rules for married people.

If either spouse has family coverage, both spouses are treated as having family coverage. If both spouses have separate family HDHPs, both spouses are treated as having family coverage under the plan with the lower annual deductible. The taxpayer and the spouse divide the allowable deduction equally unless they agree upon another allocation. The "Rules for married people" apply only if both spouses are eligible individuals.

If the taxpayer and the spouse have a family HDHP and either spouse has an Archer MSA, the HSA contribution limit must be reduced by the amount contributed to the Archer MSA(s) before taking into account any additional HSA contributions. After the reduction for the Archer MSA(s) contributions, the allowable HSA contribution is split equally between the spouses unless they agree on a different division.

If both spouses have an HSA and self-only HDHPs for a portion of the year and one family HDHP for the remainder of the year, the allowable deduction related to the months they had a family HDHP is divided equally unless they agree upon another allocation. For the months the spouses had HDHPs with self-only coverage, each spouse would calculate the allowable deduction for his or her own plan and then combine this amount with their portion of the allowable deduction related to the family HDHP.

> **Example.** H and W each have an HSA and HDHPs with self-only coverage until mid-March. H and W's annual deductibles were $1,200 and $2,400, respectively. H's contribution limit related to the self-only HSA is $300 ($1,200 x 3/12) and W's contribution limit for her self-only HSA is $600 ($2,400 x 3/12). In March, H and W acquire a family HDHP with an annual deductible of $2,400. The contribution limit related to this HDHP is $1,800 ($2,400 x 9/12). H and W may divide this amount equally between them or allocate it as they see fit. If H and W allocate this amount equally, H's contribution limit equals $1,200 ($300 + 900), and W's contribution limit equals $1,500 ($600 + $900).

If H and W file a joint PA-40 and contribute the maximum amount allowable to their HSAs, they would list a $2,700 deduction on their PA-40. If H and W file separate PA-40s, H would report a deduction of $1,200 and W would report a deduction of $1,500.

§ 7. Distributions from an HSA.

An individual can receive a tax-free HSA distribution either to pay or to be reimbursed for qualified medical expenses incurred after establishing the HSA. If an HSA distribution is made for any other reason, the amount withdrawn is subject to income tax. An individual does not have to make distributions from an HSA each year. Even if an individual no longer may contribute to an HSA, the individual can receive tax-free distributions to pay or to be reimbursed for qualified medical expenses.

§ 8. Deemed distributions from an HSA.

If an individual uses any portion of an HSA as security for a loan at any time during the tax year, the portion used as security is treated as distributed for a purpose other than for a qualified medical expense and must be reported as Interest Income on the PA-40.

§ 9. Recordkeeping.

An individual must maintain records sufficient to show that:

A. The distributions were exclusively used to pay or reimburse qualified medical expenses, and
B. The qualified medical expenses had not been previously paid or reimbursed from another source.

§ 10. Balance in an HSA.

An HSA is generally exempt from tax. Amounts remaining in the HSA at the end of the year are normally carried over to the next year. Earnings on amounts in an HSA are not included in income while held in the HSA.

§ 11. Death of HSA holder.

If the spouse is the designated beneficiary of an HSA holder who dies, the surviving spouse becomes the account holder. Consequently, distributions from the account used to pay the surviving spouse’s qualified medical expenses are not subject to tax.

If by reason of the death of the account holder any other person acquires the account holder's interest in an HSA, the HSA shall cease to be an HSA. The fair market value of the HSA becomes taxable to the beneficiary in the year in which the account holder died. If the beneficiary pays any of the decedent's qualified medical expenses that were incurred prior to the decedent's death, these expenses reduce the income the beneficiary is required to report provided the expenses were paid within one year of the decedent's death. Any remaining income would be reported as Interest Income on the beneficiary's PA-40.

§ 12. HSA reporting requirements.

The HSA deduction which a taxpayer reports on his PA-40 must match the HSA deduction which the taxpayer reports on his federal Form 1040. Similarly, if a taxpayer must report HSA distributions as taxable income on his federal return, the distributions must be reported as Interest Income on taxpayer's PA-40.

Also if an employer's contributions to an employee's HSA exceed the employee's allowable contribution, the portion of the employer's contribution that exceeds the allowable contribution is subject to tax. The employer should report the excessive contribution as compensation on taxpayer's W-2. If the employer fails to report the excessive contribution as compensation and consequently does not withhold tax on the excessive contribution, the taxpayer must include the excess contribution on his PA-40 as Interest Income.

Taxpayers claiming HSA contributions must report the contributions on PA-40 Schedule O, Other Deductions, and must attach a copy of the front page of their federal Form 1040 to their PA-40.