

# PENNSYLVANIA DEPARTMENT OF REVENUE

## PERSONAL INCOME TAX BULLETIN 2006-5 ARCHER MEDICAL SAVINGS ACCOUNTS ISSUED OCTOBER 23, 2006

### Personal Income Tax Bulletin 2006-5

#### Archer Medical 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.<sup>1</sup> Consequently, for tax years beginning after December 31, 2005, the taxation of Archer Medical Savings Accounts (MSAs) will follow the federal rules. Section 220 of the IRC outlines the taxability of Archer MSAs on the federal level.

The key attributes of an Archer MSA include the following:

- Small employers who establish high deductible health care plans for their employees enable their employees to meet their medical care costs through pre-tax contributions to an Archer MSA.
- Amounts paid or distributed out of an Archer MSA 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 Archer MSA that are not used to pay qualified medical expenses are includible in income and are subject to tax.
- Excess contributions to an Archer MSA are subject to tax.
- Archer MSAs are exempt from taxation.

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<sup>1</sup> 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.

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

- § 2. Definitions.
- § 3. Archer MSA contributions/deductions.
- § 4. Reporting Archer MSA contributions.
- § 5. Rules for married people.
- § 6. Distributions from an Archer MSA.
- § 7. Deemed distributions from an Archer MSA.
- § 8. Recordkeeping.
- § 9. Balance in an Archer MSA.
- § 10. Death of Archer MSA holder.
- § 11. Archer MSA reporting requirements.

**§ 2. Definitions.**

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

“Account holder.” The term “account holder” means the individual on whose behalf the Archer MSA was established.

“Archer MSA.” A trust created or organized in the United States as a medical savings account exclusively for the purpose of paying the qualified medical expenses of the account holder 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 seventy-five (75%) percent of the highest annual deductible limit permitted.
- 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.

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

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

- A. is covered as of the 1<sup>st</sup> day of that month by a high deductible health plan which was established by either –
  - 1. the individual’s employer or
  - 2. the individual if the individual is self-employed,
- B. is not entitled to Medicare benefits,
- C. has no other health care coverage except as described in “other health coverage,”
- D. cannot be claimed as a dependent on another taxpayer’s federal tax return.

“High deductible health plan” (“HDHP”). An HDHP has a higher annual deductible than a typical health plan, and the plan must meet the annual minimum and maximum deductible levels and out-of-pocket expense amount annually established. Out-of-pocket expenses include co-payments and other amounts an individual must pay for covered benefits but do not include premiums. An HDHP can provide preventive care.

- The HDHP must be established by the employer of an individual or if the individual is self-employed, the individual can establish the plan. Only a small employer may establish a plan.
- The following table shows the limits<sup>2</sup> for annual deductibles and the maximum out-of-pocket expenses for HDHPs in 2006:

Type of coverage	Minimum annual deductible <sup>2</sup>	Maximum annual deductible <sup>2</sup>	Max. annual Out-of-pocket expenses <sup>2</sup>
Self-only	\$1,800	\$2,700	\$3,650
Family	\$3,650	\$5,450	\$6,650

- An HDHP can provide “preventive care” services with no deductible or a deductible below the minimum annual deductible. Preventive care can

<sup>2</sup> Each year the dollar limits change as a result of the required annual cost-of-living adjustment.

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include routine pre-natal and well-child care, child and adult immunizations, annual physicals, mammograms, pap smears, etc.

- Some family plans have deductibles for both the family as a whole and for individual family members. If either the deductible for the family as a whole or the deductible for an individual family member is below the minimum annual deductible for family coverage (\$3,650), the plan does not qualify as an HDHP.
- 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.
- A plan which uses a network of providers shall not fail to be treated as an HDHP because of its having an out-of-pocket limitation for services provided outside its network of providers.

“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

“Qualified medical expenses.” Expenses other than most insurance premiums which qualify for the federal medical and dental expenses deduction. Such expenses could be taken by the Archer MSA account holder on a federal Schedule A if they were not paid for by an Archer MSA 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

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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.

“Small employer.” A small employer is generally an employer who had an average of fifty (50) or fewer employees during either of the last two calendar years. The definition of small employer is modified for new employers and growing employers.

“Growing employer.” A small employer may establish HDHPs and Archer MSAs for his or her employees and then grow beyond fifty (50) employees. The employer will continue to meet the requirement for small employers if he or she:

- A. Had fifty (50) or fewer employees when the Archer MSAs began,
- B. Made a contribution that was excludable or deductible as an Archer MSA deduction for the last year he or she had fifty (50) or fewer employees, and
- C. Had an average of 200 or fewer employees each year after 1996.

**§ 3. Archer MSA contributions/deductions.**

For an Archer MSA established by a small employer, the employer may make contributions to the employees’ Archer MSAs. If the employer does not make contributions, the employee may make contributions, but the employer and the employee may not both make contributions. Contributions to an Archer MSA must be made in cash. Contributions of stock or property are not permitted. Beginning with the first month that an individual is eligible for Medicare benefits, the individual can not contribute to an Archer MSA.

There are two limits on the amount an individual or an employer can contribute to an Archer MSA:

- A. The annual deductible limit. The individual or the employer can contribute up to 75 percent of the annual deductible of a family HDHP (65 percent for a self-only HDHP) provided the individual had the HDHP for the entire year.

- B. An income limit. An individual cannot contribute more than what the individual earned from the employer who established the Archer MSA, and a self-employed individual cannot contribute more than the amount of the individual's net self-employment income which is the individual's self-employment income minus expenses (including the one-half of self-employment tax deduction).

**Example.** H is self-employed and maintains an HDHP with an annual deductible of \$4,000 for his family for the entire year. Based on the annual deductible, H can contribute up to \$3,000 ( $\$4,000 \times 75\%$ ) to his Archer MSA for the year. H's self-employment income after expenses, however, is \$2,000. Thus, H is limited to a contribution of \$2,000.

A taxpayer with a self-only HDHP for twelve months 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 health plan deductible, but not more than \$5,450.

**Example.** H had an HDHP for his family for the entire year. The annual deductible was \$4,000. H can contribute up to \$3,000 ( $\$4,000 \times 75\%$ ) to his Archer MSA for the year.

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.** On July 1, 2006, H acquires an HDHP for his family with an annual deductible of \$4,000. H's contribution limit is \$1,500 ( $\$4,000 \times 6/12 \times 75\%$ ).

#### **§ 4. Reporting Archer MSA contributions.**

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

#### **§ 5. Rules for married people.**

If each spouse has family coverage under a separate plan, both 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.

If both spouses have separate Archer MSAs and the taxpayer is covered by his spouse's HDHP and the spouse's employer contributes to an Archer MSA belonging to the spouse, the taxpayer cannot make contributions to his or her own Archer MSA.

**§ 6. Distributions from an Archer MSA.**

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

**§ 7. Deemed distributions from an Archer MSA.**

If an individual uses any portion of an Archer MSA 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.

Similarly, an individual must report the cash value of an Archer MSA account as Interest Income on his PA-40 if the account is used for a prohibited transaction as described in Section 4975 of the IRC.

**§ 8. 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.

**§ 9. Balance in an Archer MSA.**

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

**§ 10. Death of Archer MSA holder.**

If the spouse is the designated beneficiary of the Archer MSA holder, 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 Archer MSA, the Archer MSA shall cease to be an Archer MSA. The fair market value of the Archer MSA 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 is reported as Interest Income on the beneficiary's PA-40.

**§ 11. Archer MSA reporting requirements.**

The Archer MSA deduction which a taxpayer reports on his PA-40 must match the Archer MSA deduction which the taxpayer reports on his federal Form 1040. Similarly, if a taxpayer must report Archer MSA 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 Archer MSA 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 Archer MSA 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.