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HSA Contributions by Partnerships and S Corporations

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HSA Contributions by Partnerships and S Corporations

-by Neil E. Harl*

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003,[1] signed into law on December 8, 2003, authorized Health Savings Accounts (HSAs). The legislation permits employer contributions to employee-established HSAs which are treated as employer-provided coverage for medical expenses under an accident or health plan to the extent the amounts do not exceed the HSA limits.[2] Employer contributions are income tax deductible and are not subject to F.I.C.A. tax.[3]

A major issue with the various passthrough entities, including partnerships and C corporations, is how to handle a partnership's contributions to a *partner's* Health Savings Account and the appropriate treatment of an S corporation's contributions to a 2-percent shareholder-employee's HSA.[4] In general, employee benefits of any person owning more than two percent of the stock of an S corporation is treated in the same manner as partners are treated in a partnership.[5]

Guidance has been published by the IRS addressing both questions.[6]

Handling a partnership's contributions to a partner's HSA

Contributions by a partnership to a partner's HSA are not considered to be contributions by an employer to the HSA of an employee.[7] Rather, such contributions that are treated as distributions to the partner under I.R.C. § 731 are not deductible by the partnership and do not affect the distributive shares of partnership income and deductions.[8] The contributions are reported as distributions of money on the Schedule K-1 to Form 1065.[9] These distributions are not included in the partner's net earnings from self-employment[10] inasmuch as distributions under I.R.C. § 731 do not affect a partner's net earnings from self-employment. That is because the distributions under I.R.C. § 731 do not affect a partner's distributive share of partnership income or loss.[11] If eligible, a partner is entitled to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on the partner's federal income tax return.[12]

A partnership's contributions to a partner's HSA that are treated as guaranteed payments, provided the payments are derived from the partnership's trade or business and are for services rendered to the partnership, are deductible by the partnership as a trade or business expense[13] and are includible in the partner's gross income.[14] The contributions are not excludible from the partner's gross income[15] because the contributions are treated as a distributive share of partnership income.[16] Such guaranteed payments are reported as guaranteed payments on Schedule K-1 and are included in the partner's net earnings from self-employment on the partner's

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Schedule SE.[17] The partner, if an eligible individual,[18] is entitled to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on the partner's federal income tax return.[19]

S corporation's contributions to the HSA of a 2-percent shareholder

For this purpose, an S corporation is treated as a partnership and any 2-percent shareholder is treated as a partner in the partnership.[20] Therefore, contributions by an S corporation to an HSA of a 2-percent shareholder-employee, if for services rendered, are treated as guaranteed payments.[21] Thus, the contributions are deductible by the S corporation as a trade or business expense and are includible in the gross income of the 2-percent shareholder-employee.[22] Also, the 2-percent shareholder-employee is not entitled to exclude the contribution from gross income.[23]

For employment tax purposes, contributions made by an S corporation to an HSA of a 2-percent shareholder are treated as though the 2-percent shareholder employee is an employee subject to FICA tax and not as an individual subject to SECA tax.[24] However, if the requirements for exclusion under I.R.C. § 3121(a)(2)(B) are met, the S corporation's contributions to an HSA of a 2-percent shareholder-employee are not considered wages subject to FICA tax even though the amount must be included in wages for income tax withholding purposes on the 2-percent shareholder-employee's Form W-2. If eligible, a 2-percent shareholder-employee can deduct the amount of the contribution made to the 2-percent shareholder-employee's HSA during the taxable year as an adjustment to gross income on the individual's federal income tax return. Employment tax rules for employer contributions to HSAs for employees of S corporations other than 2-percent shareholder-employees are discussed in Notice 2004-2.[25]

In conclusion

Although early indications point to limited use of Health Savings Accounts, partly because of the difficulty in finding eligible trustees or custodians, nonetheless the popularity of passthrough entities including S corporations underscores the importance of the IRS guidance on the handling of contributions to HSA accounts set up by partners and 2-percent shareholder-employees of S corporations.

FOOTNOTES

[1] Pub. L. No. 108-173, § 1201, enacting I.R.C. § 223. See generally Harl, *Agricultural Law* § 28.05[21][g] (2004); Harl, *Agricultural Law Manual* § 4.03 (2004).

[2] I.R.C. § 106(d)(1).

[3] Notice 2004-2, I.R.B. 2004-2, 269.

[4] See Notice 2005-8, I.R.B. 2005-4.

[5] I.R.C. § 1372.

[6] Notice 2005-8, I.R.B. 2005-4.

[7] Notice 2005-8, I.R.B. 2005-4. See Rev. Rul. 69-184, 1969-1 C.B. 256.

[8] Notice 2005-8, I.R.B. 2005-4. See Rev. Rul. 91-26, 1991 C.B. 184.

[9] *Id*.

[10] I.R.C. § 1402(a)

[11] I.R.C. § 702(a)(8).

[12] Notice 2005-8, I.R.B. 2005-4.

[13] I.R.C. § 162.

[14] Notice 2005-8, I.R.B. 2005-4.

[15] See I.R.C. § 106(d).

[16] Treas. Reg. § 1.707-1(c).

[17] Notice 2005-8, I.R.B. 2005-4.

[18] I.R.C. § 223(c)(1).

[19] Notice 2005-8, I.R.B. 2005-4.

[20] See I.R.C. § 1372.

[21] Notice 2005-8, I.R.B. 2005-4.

[22] *Id*.

[23] *Id*. See I.R.C. § 106(d). See also Rev. Rul. 91-26, 1991-1 C.B. 184.

[24] See Ann. 92-16, I.R.B. 1992-5, 53.

[25] See I.R.B. 2004-2, 269, Q&A 19.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAXATION

DISCHARGE. The debtor filed joint income tax returns with the debtor's spouse for 1999, 2000 and 2001, returns all filed within three years of the debtor's filing for bankruptcy. The taxes for those years were assessed within 240 days of the bankruptcy filing. In each tax year, the debtor's income was small enough to not require the debtor individually to file an income tax return but the addition of the spouse's income was sufficient to require the joint return. The debtor argued that, because the debtor was not required to file a return in each year, Sections 507(a)(8)(A), (B), 523(a)(1)(A) allow the discharge of the debtor's tax liability for those years. The court held that Section 507(a)(8)(B) (taxes assessed within 240 days before the bankruptcy filing) did not apply to taxes for which a return was "required;" therefore, it was irrelevant whether or not the debtor was required to file a return in order for Section 507(a)(8)(B) to apply to make the taxes nondischargeable. The court