



## Tax Reduction Letter

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### Notice 2005-8

January 24, 2005

#### PURPOSE

This notice provides guidance on a partnership's contributions to a partner's Health Savings Account (HSA) and an S corporation's contributions to a 2-percent shareholder-employee's HSA.

#### BACKGROUND

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173, added section 223 to the Internal Revenue Code to permit eligible individuals to establish Health Savings Accounts (HSAs) for taxable years beginning after December 31, 2003. Generally, contributions made to an HSA, within permissible limits, by or on behalf of a taxpayer who is an eligible individual are deductible by a taxpayer under section 223(a). The deduction is an adjustment to gross income (i.e., an above the line deduction) under section 62(a)(19). If an employer makes a contribution, within permissible limits, to the HSA on behalf of an employee who is an eligible individual, the contribution is excluded from the employee's gross income and wages. See section 106(d). A partnership may also contribute to a partner's HSA and an S corporation may contribute to the HSA of a 2-percent shareholder-employee (as defined below). The Questions and Answers below discuss the tax treatment of HSA contributions made on behalf of such partners and 2-percent shareholder-employees who are eligible individuals.

#### QUESTIONS AND ANSWERS

Q-1. What is the tax treatment of a partnership's contributions to a partner's HSA that are treated as distributions to the partner under section 731?

A-1. Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee. See Rev. Rul. 69-184. Contributions by a partnership to a partner's HSA that are treated as distributions to the partner under section 731 are not deductible by the partnership and do not affect the distributive shares of partnership income and deductions. See Rev. Rul. 91-26, 1991-1 C.B. 184 (analysis of situation 1, last paragraph). The contributions are reported as distributions of money on Schedule K-1 (Form 1065). These distributions are not included in the partner's net earnings from self-employment under section 1402(a) because the distributions under section 731 do not affect a partner's distributive share of partnership income or loss under section 702(a)(8). The partner, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return.

Q-2. What is the tax treatment of a partnership's contributions to a partner's HSA that are treated as guaranteed payments under section 707(c), are derived from the partnership's trade or business, and are for services rendered to the partnership?

A-2. Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee. See Rev. Rul. 69-184, 1969-1 C.B. 256. Contributions by a partnership to a partner's HSA for services rendered to the partnership that are treated as guaranteed payments under section 707(c) are deductible by the partnership under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and are includible in the partner's gross income. The contributions are not excludible from the partner's gross income under section 106(d) because the contributions are treated as a distributive share of partnership income under Treas. Reg. § 1.707-1(c) for purposes of all Code sections other than sections 61(a) and 162(a). See Rev. Rul. 91-26. Contributions by a partnership to a partner's HSA that are treated as guaranteed payments under section 707(c), are reported as guaranteed payments on Schedule K-1 (Form 1065). Because the contributions are guaranteed payments that are derived from the partnership's trade or business, and are for services rendered to the partnership, the contributions are included in the partner's net earnings from self-employment under section 1402(a) on the partner's Schedule SE (Form 1040). The partner, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return.

The following example illustrates the answers in A-1 and A-2.

Example. Partnership is a limited partnership with three equal individual partners, A (a general partner), B (a limited partner), and C (a limited partner). C is to be paid \$500 annually for services rendered to Partnership in his capacity as a partner and without regard to Partnership income (a section 707(c) guaranteed payment). The \$500 payment to C is derived from Partnership's trade or business. Partnership has no employees. A, B, and C are eligible individuals as defined in section 223(c)(1) and each has an HSA. During Partnership's Year 1 taxable year, Partnership makes the following contributions: a \$300 contribution to each of A's and B's HSAs which are treated by Partnership as section 731 distributions to A and B; and a \$500 contribution to C's HSA in lieu of paying C the guaranteed payment directly.

Partnership's contributions to A's and B's HSAs are not deductible by Partnership and, therefore, do not affect Partnership's calculation of its taxable income or loss. See Rev. Rul. 91-26. A and B are entitled to an above the line deduction, under sections 223(a) and 62(a)(19), for the amount of the contributions made to their individual HSAs. The section 731 distributions to A's and B's individual HSAs are reported as cash distributions to A and B on A's and B's Schedule K-1 (Form 1065). The distributions to A's and B's HSAs are not includible in A's and B's net earnings from self employment under section 1402(a), because distributions under section 731 do not affect a partner's distributive share of the partnership's income or loss under section 702(a)(8).

Partnership's contribution to C's HSA that is treated as a guaranteed payment under section 707(c) for services rendered to the partnership is deductible by Partnership under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and is includible in C's gross income. The contribution is not excludible from C's gross income under section 106(d) because the contribution is treated as a distributive share of partnership income

for purposes of all Code sections other than sections 61(a) and 162(a), and a guaranteed payment to a partner is not treated as compensation to an employee. See Rev. Rul. 91-26. The payment to C's HSA should be reported as a guaranteed payment on Schedule K-1 (Form 1065). Because the contribution is a guaranteed payment that is derived from the partnership's trade or business and is for services rendered to the partnership, the contribution constitutes net earnings from self-employment to C under section 1402(a) which should be reported on Schedule SE (Form 1040). C is entitled under sections 223(a) and 62(a)(19) to deduct as an adjustment to gross income the amount of the contribution made to C's HSA.

Q-3. What is the tax treatment of an S corporation's contributions to the HSA of a 2-percent shareholder (as defined in section 1372(b)) who is also an employee (2-percent shareholder-employee) in consideration for services rendered to the S corporation?

A-3. Under section 1372, for purposes of applying the provisions of Subtitle A that relate to fringe benefits, an S corporation is treated as a partnership, and any 2-percent shareholder of the S corporation is treated as a partner of such partnership. Therefore, contributions by an S corporation to an HSA of a 2-percent shareholder-employee in consideration for services rendered are treated as guaranteed payments under section 707(c). Accordingly, the contributions are deductible by the S corporation under section 162 (if the requirements of that section are satisfied (taking into account the rules of section 263)) and are includible in the 2-percent shareholder-employee's gross income. In addition, the 2-percent shareholder-employee is not entitled to exclude the contribution from gross income under section 106(d). See Rev. Rul. 91-26.

For employment tax purposes, when contributions are made by an S corporation to an HSA of a 2-percent shareholder-employee, the 2-percent shareholder-employee is treated as an employee subject to Federal Insurance Contributions Act (FICA) tax and not as an individual subject to Self-Employment Contributions Act (SECA) tax. (See Announcement 92-16, 1992-5 I.R.B. 53, clarifying the FICA (Social Security and Medicare) tax treatment of accident and health premiums paid by an S corporation on behalf of a 2-percent shareholder-employee.) However, if the requirements for the exclusion under section 3121(a)(2)(B) are satisfied, the S corporation's contributions to an HSA of a 2-percent shareholder-employee are not wages subject to FICA tax, even though the amounts must be included in wages for income tax withholding purposes on the 2-percent shareholder-employee's Form W-2, Wage and Tax Statement. The 2-percent shareholder-employee, if an eligible individual as defined in section 223(c)(1), is entitled under sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the 2-percent shareholder-employee's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return. See Notice 2004-2, Q&A 19, 2004-2 I.R.B. 269, for employment tax rules for employer contributions to HSAs of employees other than 2-percent shareholder-employees.

#### DRAFTING INFORMATION

The principal authors of this notice are Elizabeth Purcell of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Pietro E. Canestrelli of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding HSA issues in this notice, contact Ms. Purcell on (202) 622-6080. For information regarding partnership or S corporation issues, contact Mr. Canestrelli on (202) 622-3060 (not toll-free calls).