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Take Advantage Of The HSA Loophole

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Many people know that Health Savings Accounts (HSA) are a great way to pay for qualified medical expenses with their triple-tax advantage features. However, what many people might not know is that there is an IRS loophole that will allow you flexibility in terms of the time frame you can reimburse yourself for qualified medical expense payments. These can extend well into retirement and importantly, be paid on your own terms.

Under the rules of a HSA, U.S. taxpayers who are enrolled in a high-deductible health plan (HDHP), can contribute pre-tax dollars of income that can be saved or invested, where it grows tax-free, for future qualified medical expenses. There is no income limitation either. Another plus, you do not need to have earned income at all to contribute, so retirees up to age 65 can still take advantage.

HSA distributions usually work like this: When you have a HSA and incur a qualified medical expense, you can pay for it by swiping your HSA debit card or reimbursing yourself at a later time. The kicker is that according to the IRS, there is no time limit for when you have to reimburse yourself by. This allows for the continued investment and compounding of interest of the funds in your HSA account while delaying the reimbursement of a qualified medical expense.

In 2004, the IRS explained this exact issue in a Q&A regarding HSA distributions, when they clarified the question:

Q-39. When must a distribution from an HSA be taken to pay or reimburse, on a tax-free basis, qualified medical expenses incurred in the current year?

A-39. An account beneficiary may defer to later taxable years distributions from HSAs to pay or reimburse qualified medical expenses incurred in the current year as long as the expenses were incurred after the HSA was established. Similarly, a distribution from an HSA in the current year can be used to pay or reimburse expenses incurred in any prior year as long as the expenses were incurred after the HSA was established. Thus, there is no time limit on when the distribution must occur. However, to be excludable from the account beneficiary's gross income, he or she must keep records sufficient to later show that the distributions were exclusively to pay or reimburse qualified medical expenses, that the qualified medical expenses have not been previously paid or reimbursed from another source and that the medical expenses have not been taken as an itemized deduction in any prior taxable year.

The IRS explicitly said "in any prior year" and "there is no time limit." So as long as you are diligent in your record keeping, you can delay your qualified medical expense reimbursement indefinitely, while allowing the pre-tax funds in your HSA account to grow tax-free.

Taking advantage of this HSA loophole does come with some additional tax burdens and special circumstances to keep in mind. The IRS places the burden of proof on the tax filer to prove that:

· Your HSA withdrawals were only used to pay for qualified medical expenses.

· Your medical expenses weren't paid for or reimbursed from another source.

· You didn't take an itemized deduction for these medical expenses in any year. (Double-dip)

Therefore, it is imperative that you keep immaculate detailed records of your itemized qualified medical expense receipts. If you take a distribution, your HSA provider will send you tax Form 1099-SA. Be prepared to report everything with Form 8889. If anything doesn't match, resolve it before filing your taxes.

How do you know you qualify for an HSA? You will need to check your deductibles and annual out-of-pocket expense totals. High deductible health plans (HDHP), or “HSA-eligible” health plans as they are sometimes referred to, typically have lower premiums but higher out-of-pocket potential costs. The IRS defines a HDHP, as any plan with a deductible of at least $1,350 for an individual or $2,700 for a family. An HDHP's total yearly out-of-pocket expenses (including deductibles, copayments, and coinsurance) can't be more than $6,750 for an individual or $13,500 for a family.

HSA contribution limits for 2019 are $3,500 for single filers, $7,000 for families, and an extra $1,000 added contribution catch-up amount for those 55 years and older. For calendar year 2020, the contribution amount is set to modestly increase to $3,550 for singles, and $7,100 for families. The catch-up contribution limit for those over age 55 will remain at $1,000.

HSAs also have expanded benefits after age 65. All Medicare premiums except Medigap can be paid from HSAs. There are no required distributions for HSA accounts, so any funds that have accumulated in an HSA account after age 65 are allowed to be withdrawn for non-qualified medical expenses and avoid the 20% penalty. Keep in mind though, any distributions for non-qualified medical expenses, will be taxable like 401(k) or Traditional IRA distributions.

With the triple-tax advantage feature offered by HSAs, they are the best means of saving for medical expenses in retirement. Taking advantage of the payment reimbursement loophole flexibility adds another reason to use these account towards greater savings opportunities. As always it best to consult with your tax professional to make sure deferring your reimbursements from your HSA is the right strategy for you.