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When Can You Dispose of Old Tax Records?

Taxpayers often question how long records must be kept and the amount of time IRS has to audit a return after it is filed.

You will love this answer. It all depends on the circumstances! In many cases, the federal statute of limitations can be used to help you determine how long to keep records. With certain exceptions, the federal statute for assessing additional tax is 3 years from the return due date or the date the return was filed, whichever is later. However, the statute of limitations for many states including Colorado is one year longer than the federal limitation. The reason for this is that the IRS provides state taxing authorities with federal audit results. The extra time on the state statute gives states time to assess tax based on any federal tax adjustments that also apply to the state return.

In addition to lengthened state statutes clouding the recordkeeping issue, the federal 3-year rule has several exceptions including but not limited to:

- The assessment period is extended to 6 years instead of 3 years if a taxpayer omits from gross income an amount that is more than 25 percent of the income reported on a tax return.
- The IRS can assess additional tax with no time limit if a taxpayer: (a) doesn't file a return; (b) files a false or fraudulent return to evade tax; or (c) deliberately tries to evade tax in any other manner.
- The IRS gets an unlimited time to assess additional tax when a taxpayer files an unsigned return.

Subject to many possible exceptions, you can probably discard most of your tax records that are more than 7 years old.

Examples: Susan filed her 2020 tax return before the due date of April 15, 2021. She will be able to safely dispose of most of her records after April 15, 2028. On the other hand, Don filed his 2020 return on June 1, 2021. He needs to keep his records at least until June 1, 2028.

Important note: Even if you discard backup records, never throw away your file copy of any tax return (including W-2s). Often the return itself provides data that can be used in future tax return calculations or to prove amounts related to property. You should also keep certain records for longer than 7 years. These records include but are not limited to:

- **Stock acquisition data.** If you own stock in a company, keep the purchase records for at least 7 years after the year you sell the stock. This data will be needed to prove the amount of profit (or loss) you had on the sale. Although brokers are now required in most cases to keep purchase records and report the information to the IRS when the

stock is sold, it is still a good idea for you to maintain your own records, as you the taxpayer are ultimately responsible for proving the cost to the IRS if your return is audited.

- **Stock and mutual fund statements where you reinvest dividends**. Many taxpayers use the dividends they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to basis in the property and reduce gain when it is finally sold. Keep statements at least 7 years after the final sale.

- **Tangible property purchase improvement and other investment records.** Keep records of home, investment, rental property, and business property and investment acquisitions, (related capital improvements) for at least 7 years after the underlying property is *sold*.

- **Carryforward items.** If you have carryforward items from prior year income tax returns, you will need to maintain records of transactions to support any tax benefit item or position through the conclusion of the statute period of the year in which the benefit was claimed or used (rather than the older period where the benefit/position arose).

In addition, for businesses there are additional record retention guidelines to consider that might also require keeping records longer than 7 years.

As you can see, because you might own an investment asset or other property or have other positions you may need to prove for much longer than 7 years. Its quite likely you will have some records you will need to maintain for much longer than 7 years.

As we become more and more a paperless society, you may wonder if you must keep the paper version of the records mentioned in this article. No, you don't – the paper documents can be scanned and maintained on your computer or in the cloud. But if you do convert the records to electronic files, be sure to maintain a back-up that can be retrieved if you have a computer crash or cyber attack that takes over your computer.

If you have questions about what records to retain and what you can dispose of now, please give this office a call.

What is the Difference Between an HSA and a Health FSA?

The tax code provides two tax advantageous plans for taxpayers to pay medical expenses. One is a Flexible Spending Account (FSA) and the other is a Health Savings Account (HSA). The two are often misunderstood and their provisions are frequently mixed up by taxpayers who then fail to take advantage of the tax benefits available from these accounts.

This article explains the workings, qualifications, and tax benefits of each with a side-by-side comparison chart of the two programs. Both have a common theme: contribution to both is made with pre-tax dollars (they reduce taxable income) and distributions to pay qualified medical expenses are tax free. After that the two plans are quite different.

Flexible Spending Accounts (FSAs)

There are three types of FSAs: dependent care assistance, adoption assistance and medical care reimbursements. This article will only be dealing with the latter, often referred to as a Health FSA. A Health Flexible Spending Account is part of a qualified cafeteria plan offered by an employer, that allows employees to contribute pre-tax dollars annually to be used by the employee to pay medical expenses of the employee, their spouse, and dependents during the year. The maximum contribution is annually inflation adjusted, and for 2023 is $3,050 (up from $2,850 in 2022). In the case of a married couple where each spouse has an FSA account with an employer, both can contribute the maximum.

Since an FSA is an employer plan, an employee cannot take it with them if they leave their employment. Thus, FSAs are not transferrable and cannot be rolled into an individual's health

savings plan.

Common Features of an FSA – Funds can be used for health insurance deductibles, copays, medication, and other health care related out-of-pocket costs. For ease of use, most FSA accounts come with a debit card. Employees can spend the money in the account before it's fully funded.

FSA Allowable Medical Expenses Include Those For:

- The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
- Prescription Drugs,
- Medication available without a prescription (an over-the-counter medicine or drug) that is prescribed),
- Insulin,
- Transportation primarily for and essential to medical care,
- Supplementary medical insurance for the aged,
- Feminine menstrual products, and
- Personal Protective Equipment (COVID)
-

No Double Dipping – Medical expenses reimbursed from the FSA cannot be claimed as a Schedule A medical itemized deduction.

Unused Amounts (Use It or Lose It) – Unused amounts at the plan's year end are generally forfeited by the employee. However, a plan can have either:

- A grace period of up to 2½ months after the end of the plan year in which to use up the unused amount or
- Allow up to 20% of the annual contribution limit ($610 for 2023) of unused amounts from the end of the plan year to be used to pay or reimburse qualified medical expenses in the following year.

Unused amounts more than the carryover amounts are forfeited (cannot be returned to the employee). The carryover amount does not reduce the maximum contribution amount allowed for the carryover year.

FSA participants need to pay close attention to their FSA account balances to ensure they do not forfeit any funds at year's end.

Health Saving Accounts (HSAs)

Individuals must meet the following requirements to contribute to an HSA:

- Not be claimed as a dependent on anyone else's tax return.
- Not be enrolled in Medicare.
- Covered under a high-deductible health plan (HDHP) and not be covered under any other health plan which is not an HDHP, unless the other coverage is permitted insurance or coverage for accidents, disability, dental care, vision care, or long-term care.

Enrolled in Medicare – The IRS has interpreted being "enrolled in Medicare" to mean both eligibility for and enrollment in Medicare. An individual who is otherwise eligible, but who is not enrolled in Medicare Part A, may contribute to an HSA until the month enrolled in Medicare.

Covered Under a High-deductible Health Plan – HDHPs come in two varieties: Self-Only plans and Family plans. Use the flow chart below to determine if a plan qualifies as a high-deductible health plan.

HSA Contributions and Contribution Limits – Individuals may establish an HSA either independently or with their employer. If made with an employer, and the individual subsequently leaves the employment, the individual can roll the funds into their own HSA or take a taxable distribution subject to a 20% penalty.

In addition to the individual, others can make contributions to the HSA, including employers as well as other persons (e.g., family members) subject to the annual inflation adjusted

contribution limits. Those limits for 2023 are:

- $3,850 for self-only coverage
- $7,750 for family coverage
- $1,000 additional amount for those aged 55 and older.

An account holder gets the deduction for contributions to his HSA even if someone else (e.g., a family member) makes the contributions. Employer contributions to an HSA are excluded from the employee's income – so these contributions are not deducted on the employee's tax return. Distributions for qualifying medical expenses are tax-free.

HSA Allowable Medical Expenses – Generally the eligible medical expenses are the same as allowed for FSAs. The qualified medical expenses must be incurred only after the HSA has been established. Medical expenses paid or reimbursed by HSA distributions cannot also be claimed as a medical expense for itemized deduction purposes.

HSA as a Supplemental Retirement Vehicle – Establishing and contributing to an HSA can be more than just a way for individuals to save taxes and gain control over their medical care expenditures. It can also be a retirement vehicle, especially for taxpayers who are maxed out on their other retirement plan options or who can't contribute to an IRA because of the income limitations.

There is no requirement that medical expenses must be paid or reimbursed from the HSA, so a taxpayer can maximize tax-free growth in the account by using funds from other sources to pay routine medical costs. Later, distributions can be used tax-free to pay post-retirement medical expenses. Or, if used for non-medical purposes, a retiree aged 65 or older will pay income tax on the distribution, but not a penalty. Those younger than 65 who use their HSA funds for other than qualified medical purposes pay a penalty of 20% of the amount distributed in addition to income tax on the distribution. Unlike IRAs, no minimum distributions are required to be made from HSAs at any specific age.

FSA-HSA Comparison Table

The following table compares the key differences between Health Flexible Spending Accounts and Health Savings Accounts:

DIFFERENCES BETWEEN FSA AND HSA ACCOUNTS		
Attributes	**Health Flexible Spending Account (FSA)**	**Health Savings Account (HSA)**
Establishment	FSAs are only available through an employer. Thus they cannot be set up by a taxpayer on their own.	An HSA can be established independently by a taxpayer or through an employer. Those established through an employer can be rolled to an independent account when leaving employment
Eligibility	Have an employer with an FSA	Have a high deductible health plan (HDHP), not be covered by any other health plan that is not a HDHP, not be entitled to Medicare benefits and not be a dependent of another.
Plan Control	FSAs are employer plans owned and controlled by the employer	HSAs are individual plans, and not tied to employment, though some employers may contribute to them.
Contribution Limits	Contribution limits are annually adjusted for inflation. For 2023 the maximum contribution is $3,050.	Contribution limits are annually adjusted for inflation. For 2023 for self-only coverage the maximum contribution is $3,850 and family coverage is $7,750. In addition, those aged 55 and over can contribute an additional $1,000.
Spending Requirements	FSAs have an annual "use it or lose it" feature. Depending upon the employer, plans can allow up to 20% of the annual cap ($610 for 2023) to be carried over to the subsequent year **OR** allow the annual spending requirement to be extended by 2.5 months.	HSAs have no annual spending requirements, and the funds can be carried over indefinitely. Some taxpayers treat HSAs as a supplemental retirement plan and allow the account to accrue until they retire.
Key Tax Benefits	Contributions made to an FSA are made with pre-tax dollars and are not subject to payroll or income taxes. Distributions made for qualified medical expenses are not subject to income tax.	Taxpayer contributions made to an HSA are tax-deductible. Employer contributions are excludable from taxable income. Distributions made for qualified medical expenses aren't subject to taxes. Distributions not made for qualified medical expenses are subject to a 20% penalty tax if the taxpayer is younger than age 65, unless disabled or deceased.

As you can see, either an FSA or HSA can help you pay your out-of-pocket medical expenses. On top of that, contributions are made on a pre-tax basis directly reducing your taxable income. If in an employer plan, in addition to reducing your taxable income, contributions reduce payroll taxes. Plus an HSA can be a supplemental retirement vehicle.

Please give this office a call if we can help you utilize the tax benefits of a health FSA or an HSA.

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