Health Flexible Spending Accounts - Unsubstantiated Expenses

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Question: We switched to a new health Flexible Spending Account (FSA) third-party administrator (TPA). The new TPA deactivated one of our employee's FSA debit card because of $20 in unsubstantiated expenses, stating this was an Internal Revenue Code requirement. Our prior TPA told us expenses under $25 did not need to be substantiated and that the TPA would never deactivate an employee's debit card because of unsubstantiated expenses. Who is right?

Summary:

In the eyes of the Internal Revenue Service (IRS), your new TPA is correct. FSA debit cards have many expenses that can be auto-substantiated. Others need to be substantiated after the "swipe". For claims that cannot be auto-substantiated, the employee must provide third-party provider/merchant documents to substantiate the claim. If the employee does not provide these documents, there are five required steps an employer must take to seek repayment of the unsubstantiated claim(s) (outlined in the detail section below). While there is some leeway in some of the steps, according to the IRS, the deactivation of the debit card must come first.

Employers should look closely at any TPA that asserts it will never deactivate the debit card. What the TPA may mean is it will never, of its own accord, deactivate a debit card and will only do so if directed by the employer. The TPA may or may not inform the employer about the IRS requirements for card deactivation. So, the employer may not be aware that it should direct the TPA to deactivate the debit card.

Also, the IRS has made it clear that all claims, even those for less than a dollar, need to be substantiated. There is no "de minimis" exception.

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If FSA claims are not substantiated, the IRS could assert that the employer's entire cafeteria plan is invalid. All employees who believed they were pre-taxing benefits would be taxed. This would include amounts paid on a pre-tax basis not only for the FSA but also for group medical, dental, vision etc. If this failure is discovered in a subsequent tax year, there would likely be interest and penalties for employees, employer penalties for a failure to withhold, and both employee and employer FICA and FUTA implications.

Detail:

A. Substantiation Generally

In Revenue Ruling 2003-43, the IRS stated all FSA claims must be substantiated, but noted the Code itself did not provide specifics on substantiation methods. That Revenue Ruling was the first substantial guidance on auto-substantiation of FSA claims with a debit card. Revenue Ruling 2003-43 is also significant in establishing what would not constitute substantiation. In this Revenue Ruling, the IRS rejected sampling techniques based on transaction amounts. For example, a review of 20 percent of dental office transactions paid with the card that have not been otherwise substantiated and are above $100 would not constitute valid substantiation. Similarly, the IRS rejected substantiation procedures where card transactions below a low dollar threshold (e.g., $25) were not substantiated.

Therefore, any TPA that informs an employer that small claims do not need substantiation is providing guidance contrary to Revenue Ruling 2003-43.

B. Auto-Substantiation

The IRS does allow auto-substantiation for certain debit card transactions. An explanation of all the "ins and outs" of these rules is beyond the scope of this Q&A; but, for medical providers as well as for what are known as "90% pharmacies," the categories of transactions that can be auto-substantiated are: co-pays matching claims, recurring previously approved claims, and real-time verified claims. Also, many merchants, even those who are not medical providers or 90% pharmacies, have instituted an inventory information approval system (IIAS) that can work with debit cards for auto-substantiation.[1] Still, a number of debit card transactions cannot be auto-substantiated. This is especially true for dental, chiropractic, and medical expenses that don't match exactly to dental or medical co-pays. While these debit card transactions are not substantiated at the time of the "swipe," they are still unlike other claims in that they are subject to after-the-fact substantiation after payment instead of substantiation before payment. The employee's failure to follow through with this after-the-fact substantiation is what usually triggers the required "pay and chase" procedures discussed on the following page.

C. After-the-Fact Substantiation/Pay and Chase

Revenue Ruling 2003-43 and the proposed cafeteria plan regulations are consistent that certain procedures must be followed for claims that are not substantiated. Under the proposed regulations, the following steps/procedures must be followed in order.[2]

1. Until the amount of the improper payment is recovered, the debit card must be de-activated and the employee must request payments or reimbursements of medical expenses from the FSA through other methods (for example, by submitting receipts or invoices from a merchant or service provider through a manual claim submission).
2. The employer demands the employee repay the cafeteria plan an amount equal to the improper payment.
3. If, after the demand for repayment of improper payment..."the employee fails to repay the amount of the improper charge, the employer withholds the amount of the improper charge from the employee's pay or other compensation, to the full extent allowed by applicable law."
4. If, after procedures 2-3, any portion of the improper payment remains outstanding after attempts to recover the amount ... "the employer applies a claims substitution or offset to resolve improper payments, such as a reimbursement for a later substantiated expense claim that is reduced by the amount of the improper payment. So, for example, if an employee has received an improper payment of $200 and subsequently submits a substantiated claim for $250 incurred during the same coverage period, a reimbursement for $50 is made."
5. If, after procedures 2-4, the "employee remains indebted to the employer for improper payments, the employer, consistent with its business practice, treats the improper payment as it would any other business indebtedness."

In 2014, however, the IRS issued a Chief Counsel's Advice Memorandum (Advice Memorandum) about the pay-and-chase rules. Under this Advice Memorandum, the IRS stated steps 2-4 above could be applied in any order as long as they were applied consistently among employees. What this means is that step 1, deactivating the debt card, must be the first step in any procedure. Step 5, which is essentially including the amount of the unsubstantiated expense in the income of the employee after exhausting collection procedures, must come last. Also, steps 2 and 4 should be performed during the "period of coverage" (almost always the plan year) in which the claim was paid.

The one exception appears to be that the employer should go directly to step 5 where steps 2 through 4 have not been performed during the plan year.

The Advice Memorandum should not, however, be read to give the employer the leeway to just skip steps 2-4 during the plan year and go to step 5 during the subsequent year. First, the Advice Memorandum indicates step 5 should come last. Second, the IRS stated "forgiveness of improper payments as uncollectible business indebtedness should be the exception rather than a routine process. Repeated inclusion in income of improper payments suggests that proper substantiation procedures are not in place or that the payments may be a method of cashing out unused FSA amounts." In other words if an employer, year after year, defaults to including unsubstantiated amounts in an employee's income, that demonstrates a lack of substantiation and the entire cafeteria plan could be jeopardized as discussed later in this Q&A.

The reference to going to step 5 where steps 2 through 4 have not been accomplished during the plan year, therefore, likely alludes to instances where the improper payment is made toward the end of the plan year, and there is simply no time to go through steps 2-4.

Also, please note, step 3 (with regard to withholding from pay) stipulates this procedure should be applied only "to the full extent allowed by applicable law." Before applying this step, an employer should check any applicable state law on withholding amounts from pay or wages.[3]

The Advice Memorandum also clarified proper reporting for step 5:

> *The improper payment should be reported by the employer to the employee as wages on a Form W-2 to the extent the employer forgives the indebtedness after requesting payment consistent with collection procedures for other business indebtedness." The amount included in income is subject to withholding for income tax, FICA and FUTA, since the benefits are made available to the employee by the employer for the performance of services. The improper payment is reportable in the taxable year of the employee in which the indebtedness is forgiven.*

In other words, the unsubstantiated claim is included in the employee's W-2 income in the year it is "written off" and subject to employee and employer payroll taxes.

For each claim paid with the debit card, even those with auto-substantiation, the employee must obtain and retain the documentation necessary to substantiate the claim in accordance with traditional rules. This documentation may be needed if the employee is audited, even though additional substantiation was not a pre-requisite to payment. Indeed, the proposed regulations provide as a condition of using the debit card the employee must agree "he or she will acquire and retain sufficient documentation (including invoices and receipts) for any expense paid with the debit card."[4]

D. Penalties for Failing to Substantiate

The proposed cafeteria plan regulations address the failure to substantiate FSA claims in two contexts. First, those regulations provide that if there is inadequate substantiation then all amounts under the FSA that reimbursed medical expenses would be included in an employee's gross income—even those that were substantiated.[5] But the regulations go much further and list certain operational failures where the entire plan would not be a cafeteria plan and "employees' elections between taxable and nontaxable benefits result in gross income to the employees." Among those operational failures listed is the failure to substantiate FSA expenses.[6] In other words, the IRS takes the position that all amounts employees believed they were pre-taxing through the cafeteria plan would be taxable—and that includes amounts for group medical, dental, vision etc.

Conclusion:

Debit cards for an FSA are a very useful employee benefit. They do not, however, resolve all substantiation questions. There will be "swipes" of the card requiring additional substantiation. Any TPA that indicates differently does not have a firm grasp of the Code requirements regarding substantiation. Also, for an employer of any significant size, there will likely be employees who do not provide the additional substantiation. The first required step in this instance is deactivating the debit card. Once again, any TPA that indicates differently is putting the favorable tax status of the employer's cafeteria plan in jeopardy. Finally, all claims must be substantiated either through auto-substantiation (if eligible) or through more traditional substantiation. There are no "short cuts," such as sampling or not substantiating small claims.

References

1 - IRS Notice 2006-69 describes IIAS substantiation and clarifies other methods of automatic substantiation.

2 - See Prop. Treas. Reg. §1.125-6(d)(7). These regulations were proposed in 2007 but specifically provide that employers and other taxpayers may rely on the proposed regulations until final regulations are issued.

3 - With respect to a FSA, which is a form of self-insured group health plan, any state law prohibiting withholding from wages may be preempted by ERISA. See: DOL Advisory Opinion 2008-02A, DOL Advisory Opinion 96-01A and DOL Advisory Opinion 94-27A.

4 - Prop. Treas. Reg. §1.125-6(d)(1).

5 - Prop. Treas. Reg. §1.125-6(b)(3)

6 - Prop. Treas. Reg. §1.125-1(c)(7)(ii)(G)

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