

Debit Cards and Flex Spending Accounts: IRS Expands Substantiation Requirements

The IRS recently published Notice 2006-69 to clarify and expand the substantiation methods for use with “stored value” cards as first outlined in Revenue Ruling 2003-43. Since 2003, the IRS has formally permitted the use of debit cards, credit cards, and stored value cards as a mechanism for reimbursing participants under a self-insured medical reimbursement plan (such as a flexible spending account or a health reimbursement arrangement).

The most recent guidance clarifies certain substantiation requirements that apply to all medical reimbursement plans, whether or not a card is used. Additionally, the notice provides specific guidance on the method of reimbursing an individual from a dependent care flexible spending account. The guidance also significantly expands the substantiation requirements for debit, credit, and stored value cards. IRS Notice 2006-69 may be found at the following link: <http://www.irs.gov/pub/irs-drop/n-06-69.pdf>

Background

In May 2003, the Internal Revenue Service issued Revenue Ruling 2003-43 which enabled employers to administer permitted reimbursements through debit or credit cards under certain conditions where individuals incurred qualifying medical expenses, and in some cases, the individuals would not be required to substantiate the medical expense. Under this Revenue Ruling, credit, debit, and stored value cards were expressly permitted for health FSA and HRA benefit options, as long as the plan sponsor:

- Obtained certification from the employee that:
 - the card would only be used for eligible medical expenses that could not or would not be reimbursed under another source; and
 - the card would not be used for expenses which were not eligible for reimbursement;
- Maintained a system for verifying that each expense actually charged to the card was an eligible expense, and
- Implements a process for recovery of ineligible charges.

The Revenue Ruling described situations in which the use of the debit card for reimbursement under an FSA or HRA satisfied, as well as failed to satisfy, IRS standards. The key to approval from the IRS centered on adequate plan controls. These controls were designed to monitor certification and documentation processes to ensure that the card was used only for appropriate expenses.

For example, participants who use a card must certify upon enrollment, and each plan year thereafter, that (i) they will only use the card for eligible medical expenses for themselves, their spouses, and dependents, and that (ii) any expenses paid with the card have not been reimbursed (and reimbursement will not be sought under any other plan). Moreover, the IRS imposed follow-up and substantiation requirements to assure that such cards were used only for medical expenses that were not otherwise covered under the medical plan.

In the 2003 Revenue Ruling, the IRS determined that claims would be deemed substantiated with a simple card when:

- The dollar amount of the charge matched the health plan’s required copay; or
- Recurring expenses were made on a regular basis for the same amount and at the same merchant or health care provider; or
- Charges were made at a merchant, health care provider, or other independent third party that, at the point of sale, provided information that the charges were permissible medical expenses.

Under the ruling, the IRS also stated that reimbursement programs which only randomly examined claims would not be permitted under the IRS guidance. This limitation affected employers who implemented a system to audit claims on a “sampling” basis. The IRS specifically rejected the sampling technique, characterizing it as an invalid substantiation model. Instead, employers could either have the reimbursement program pay the expenses and, if a claim was later shown to be unreimbursable, the plan must require

the employee to repay the amount of the reimbursement either directly (through payroll deduction) or by withholding future reimbursements until the claim is repaid.

New IRS Guidance

The recent Notice 2006-69 guidance addresses three main issues:

- Debit, credit, and stored value card usage;
- Substantiation methods that apply to ALL health reimbursement plans (whether or not a card is used);
- Card usage for dependent flexible spending accounts.

I. Use of Cards

Plan sponsors are permitted to adopt additional methods of substantiating medical expenses so long as the employer's policy uses certifications and corrective procedures that add the reimbursement back into the employee's gross income if the reimbursement is not substantiated at the time of the sale or shortly thereafter.

The following are additional substantiation methods that an employer might choose to adopt:

Copayment Amounts Match Payment for Multiple Services

Although the guidance in Revenue Ruling 2003-43 provided automatic substantiation for the payment of a single copay amount as long as the billed amount exactly matched the copay (and the service provider was a health care merchant or medical service provider), the latest guidance expands this automatic substantiation to situations in which multiple copayments are billed at one time. Under this approach, if the health plan requires copayments, and the dollar amount of the transaction equals an exact multiple of not more than five times the copayment for a specific service under the health plan, then the charge is automatically substantiated with no requirement to submit a receipt to the plan.

In addition, if a health plan has multiple copayments for a benefit (as in the case of tiered copayments for a pharmacy benefit), then any combination of the tiered copayments will be automatically substantiated as long as the bill exactly matches multiples or combinations of the copayments, but not more than five times the maximum copayment for that service.

However, in cases where the dollar amount of the transaction is greater than five times the amount of the copayment, then the plan cannot treat the expense as automatically substantiated. Instead, the plan must treat the claim as "conditional," pending confirmation of the charge. In that case, the employer must require third-party receipts that describe the service or product, the date of the service, and the amount to be submitted for review and substantiation.

Example 1: Widget, Inc. reimburses health FSA claims through the use of debit cards. Ann is a participant in the Widget, Inc. health FSA and is enrolled in the Widget, Inc. health plan. The health plan has a \$5.00 copay for generic prescriptions and a \$10.00 copayment for all other prescriptions.

Ann uses the card at Cornerdrug Store to purchase five brand-name prescriptions for a cost of \$50.00. Widget, Inc.'s electronic system matches the amount of the transaction with the \$10.00 copay for name-brand prescriptions along with the fact that the transaction is billed by the Cornerdrug Store pharmacy. Since the amount of the transaction is exactly five times the maximum copayment for prescriptions (and because the transaction occurs at a pharmacy), the transaction is automatically substantiated.

Example 2: Same facts as above, except that just before getting to the register to pay for her purchase, Ann remembers that she is almost out of aspirin, decongestant, and cough syrup, so she picks up the nonprescription items. In addition to her five brand-name prescriptions at \$50.00, Ann also has \$13.00 worth of nonprescription medication. Since her total bill is \$63.00, which exceeds five times the maximum copayment, the transaction must be substantiated independently through the submission of a receipt indicating that Ann incurred a medical expense, the date of the purchase, and the amount of the purchase.

Inventory Information Approval System

Under this substantiation method, the card processor uses an electronic system that automatically approves and rejects transactions, whether or not they are billed through merchants who are health care providers. Transactions that are approved through this method are automatically substantiated with no requirement to submit a receipt or other information.

An employer that uses this method would allow employees and covered dependents to make purchases

on the card as long as the merchants or service providers use an electronic database that catalogs each item and indicates that the item qualifies as a medical expense under Internal Revenue Code Section 213(d). If the transaction is only partially approved (only some of the purchased items constitute “medical expenses”), then the employee will be required to separately pay for the non-approved items. This electronic inventory system provides a “real-time” substantiation of expenses. An employee attempting to use the card to purchase items from a merchant or health care provider that does not use an electronic inventory system would have his/her card rejected and would have to pay for the goods in an alternate fashion.

Example: Bill is covered under his employer’s health plan and also has a health FSA through his employer. The employer permits employees to make health care purchases/payments at any merchant or health care provider using an electronic inventory system. Bill fills his gas tank at “Gas ‘n Shop,” and when he goes in to pay for the gas, he picks up some aspirin for his headache and decides to wash the aspirin down with a slushee.

Gas ‘n Shop is not a health care merchant, but it does have an inventory system that relies upon SKU numbers. Bill tries to pay for the gas, slushee, and aspirin with his FSA card. Because Gas ‘n Shop has an electronic inventory system, the payment card processor only permits Bill to pay for the aspirin on the FSA card. The remaining Gas ‘n Shop balance must be paid by other means.

Effective Date

With respect to this inventory system substantiation method, the guidance in IRS Notice 2006-69 will apply for plan years beginning after December 31, 2006. After the applicability date, employers that choose to use the inventory system must follow the parameters of this guidance. Although the IRS chose to specify an effective date for *only* the inventory system substantiation, we believe that plan sponsors may immediately choose to rely on Notice 2006-69 in its entirety and conform their plans, accordingly.

II. Substantiation Issues

Third Party Substantiation

Those claims for which an employer receives information from an independent third party (for example, an EOB furnished by an insurance company) that establishes both the date of service and the

amount of the bill for which the employee is responsible will be considered fully substantiated.

Employee Certification Not Permitted

Independent substantiation is always required for FSAs and HRAs. Although substantiation can be accomplished electronically (and automatically) through means that were outlined in Revenue Ruling 2003-43 and further clarified by IRS Notice 2006-69, substantiation remains the key concern. An employee’s self-certification is not permitted under any circumstances, whether the employee’s certification is verbal, written, notarized, faxed, emailed, or otherwise provided.

Further, Treasury Regulation Section 1.105-2 states that all amounts paid under a plan that permits “self-substantiation” or “self-certification” are included in the employee’s gross income, whether or not the expenses constitute “medical expenses” or are later substantiated.

III. Dependent Flexible Spending Accounts

Although an employer may use card reimbursement to provide benefits under its dependent care assistance plan (including a dependent flexible spending account), the dependent care expenses cannot be reimbursed before they are incurred. Under the rules, services are “incurred” when the dependent care services are actually provided and not when the participant is billed or pays for the care.

With this rule in mind, an employer may nevertheless adopt a special payment arrangement at the beginning of the plan year or when the employee enrolls in the dependent FSA. The employee may pay initial day care expenses to the dependent care provider, and once the dependent care provider substantiates the dates and amounts that it will charge for its previously-provided services, the employer may periodically credit the card an amount equal to the lesser of either: 1) the incurred and substantiated expense; or 2) the employee’s salary reduction amount to date. In no event, however, may the employer credit the card until after the services have been provided.

Recurring charges from the dependent care provider can be treated as substantiated without further review if the charges do not exceed the previously substantiated amount. In the event that there is an increase in the cost of the dependent care service, then the employee must submit a new statement from the dependent care provider.

U.S. Benefit Office Locations

Anchorage, AK (907) 562-2266	Atlanta, GA (404) 224-5000	Austin, TX (800) 861-9851	Baltimore, MD (410) 527-1200
Birmingham, AL (205) 871-3871	Boise, ID (208) 340-0645	Boston, MA (617) 437-6900	Cary, NC (919) 459-3000
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