

NEW GUIDANCE ON USING DEBIT/CREDIT CARDS WITH HRAS AND HEALTH AND DEPENDENT CARE FSAS

In 2003, the Internal Revenue Service provided the first guidance regarding use of a debit, credit or stored value card (collectively the "Cards") to access amounts in a health flexible spending account ("FSA") or health reimbursement arrangement ("HRA"). The guidance authorized three methods of automatic substantiation of an expense's eligibility via either co-payment match, recurring expense or real time substantiation (exchange of information at the time of the transaction). The 2003 guidance also required that all other transactions be treated as conditional pending receipt of substantiation that the expense was a valid medical expense.


New Substantiation Methods for Health Flexible Spending Accounts and Health Reimbursement Arrangements

Notice 2006-69 (the "Notice") expands the methods by which an employer may automatically substantiate Card transactions to include situations in which an individual pays multiple co-payments at the same time for up to five times the maximum dollar amount of the co-payment for that service provider (for example, purchasing five prescriptions at one pharmacy).

The Notice also added inventory information approval systems ("IIAS"). This IIAS method requires the payment card processor to have a system for approving and rejecting Card transactions using the inventory control information or stock keeping units ("SKUs") which identify which items are eligible expenses with merchants. The merchant need not be a health care provider. If the IIAS meets the requirements and receives the transaction information, then it is automatically substantiated. The system must collect the information about the items being purchased and compares the items to determine whether the items are qualified medical expenses under section 213(d). The merchant system or payment card processor system must then total the amounts that are eligible as 213(d) medical expenses and approve the use of the Card for only the amount of the 213(d) medical expense, or if less, the amount of coverage on the Card. The merchant's transaction system must require the individual to pay for any amounts not eligible as medical expenses. If the employer's plan has a vendor that uses an IIAS that satisfies the substantiation requirements, the employer is still responsible for complying with all the record keeping requirements. Thus, Employers may want to inquire regarding what (1) assurances the vendor can provide that the IIAS is able to provide the records substantiating that only medical expenses were reimbursed, and (2) testing has been done with the merchant systems and the IIAS to verify the IIAS limits payments on the Card to only qualified medical expenses. Any attempt to use the Card at a non-participating merchant or service provider must be rejected. Use of the IIAS in lieu of or in addition to other substantiation methods is effective for Plan Years beginning after December 31, 2006.

The Notice clarifies that an employer can also rely on information from an independent third party such as an explanation of benefits that indicates the amount the employee is responsible to pay without any further review and may pay the claim from the FSA or HRA based on such EOB.

The Notice does not change the Internal Revenue Service's position in prior guidance that statistical sampling is not sufficient to substantiate that only medical expenses are reimbursed by the plan. The Notice states that individuals cannot substantiate an expense solely by their representation or statement without providing additional substantiation (*i.e.*, receipts). Any amounts that are paid under a plan that permits self-substantiation or self-certification of medical expenses results in **all** amounts that are reimbursed under that plan being included in the gross income of the respective individuals, including amounts that were reimbursed for medical expenses.



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Dependent Care Flexible Spending Accounts

The Notice also provides for rules for using Cards to pay dependent care assistance plan flexible spending amounts. Using Cards to reimburse expenses under a dependent care FSA presents distinct issues, since dependent care expenses cannot be reimbursed until after they are incurred, and dependent care expenses are treated as being incurred when the services are provided. In most situations the employee must pay for the dependent care services before they are provided. Thus a Card cannot be used to reimburse the first expenses incurred at the beginning of the plan year. Instead the employee must fund the initial payments of dependent care expenses, provide the plan substantiation of such expenses, and then subsequent payments can be made with the Card. The Card can be used for subsequent payments provided the plan only makes available on the Card an amount equal to the lesser of (1) the amounts that previously incurred and substantiated, or (2) the employee's salary reductions to date. The amount available through the Card can only be increased after additional expenses have been incurred.

If you have any questions regarding the foregoing, please feel free to contact one of the attorneys listed below.

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