

IRS Explains High Standards for Substantiating FSA Claims

The IRS recently released a Chief Counsel Advice (“CCA”) which addressed numerous situations regarding the substantiation of claims under a health flexible spending account (“FSA”) and a dependent care FSA. A CCA is issued by the IRS’s Office of Chief Counsel generally to an IRS field office in response to a request for assistance related to a taxpayer. While a CCA cannot be used or cited as precedent, it provides useful information on the Office’s position on tax issues. Specifically, the IRS concluded in the CCA that when any expense of an employee is reimbursed by an FSA without being properly substantiated, the amount of the reimbursement is included in the gross income of such employee, including situations of:

- Expenses only self-certified by the employee;
- Substantiation only by random sampling;
- De minimis reimbursements without substantiation;
- No substantiation of charges from favored providers; and
- Advance substantiation for dependent care FSA expenses.

While the CCA does not reveal any new information, it serves as a reminder of the importance of proper substantiation of claims when using a health FSA and/or a dependent care FSA and the consequences for failing to have proper procedures in place.

■ Background

Internal Revenue Code sections 105(b), 125, and 129, and related regulations, set forth general rules allowing employers to set up FSAs for health care and dependent care expenses for employees, essentially through a cafeteria plan of an employer. If proper rules are followed:

- Employees can fund FSAs through salary reduction elections, which reduce their gross income for purposes of federal income taxes, state income taxes (most states), and FICA; and
- Employee expenses can be reimbursed for health care and dependent care expenses, including through the use of a debit card, and such reimbursements are not included in the employee's gross income.

A core component of the tax-favored treatment of these programs is that employees adequately substantiate all claims. Thus, the failure to meet the substantiation requirement can result in the loss of the employees' tax benefits from the FSA. Further, it can result in the cafeteria plan losing its tax-favored status – resulting in the loss of tax-favored treatment of employees' salary reduction elections for any benefits elected through the cafeteria plan.

■ The CCA

The CCA addressed two broad issues:

1. Must medical expenses reimbursed to an employee under a health FSA, where such expenses are not substantiated pursuant to guidance, be included in an employee's gross income?
2. Are expenses properly substantiated when certain short-cuts are allowed, or when dependent care expenses are substantiated only before they are incurred?

The CCA addressed six separate situations, one of which clarified what may be considered as compliant with substantiation requirements, and the other five illustrating situations that would fall short of meeting such requirements:

Example of meeting the substantiation requirements

A cafeteria plan with a health FSA and several features, all of which resulted in the IRS concluding the arrangement met substantiation requirements:

- Expenses are substantiated by information from an independent third party, which could include an explanation of benefits (“EOB”) from an insurance company.
- The information describes:
 - The service or product;
 - The date of service or sale; and
 - The amount of the expense, including the employee's share through an EOB.

- The plan requires employees to certify that any expense paid by the plan has not been reimbursed by insurance or otherwise and that the employee will not seek reimbursement from any other plan covering health benefits.
- Debit cards can be used for reimbursements when meeting the requirements of proposed cafeteria plan regulations.

Examples of not meeting the substantiation requirements

- **Self-certification.** A health FSA that includes a feature where only the employee provides information regarding a claim for reimbursement of medical expenses, without a statement from an independent third party verifying the expenses, does not meet substantiation requirements. Notably, the CCA references the proposed regulation that prohibits self-substantiation of medical claims.
- **Sampling.** A health FSA with a debit card feature where the plan only requires substantiation of a random sample of charges. The CCA clarified that this too falls short of meeting substantiation requirements and included citation to guidance holding that sampling does not meet substantiation requirements.
- **De minimis.** A health FSA with a debit card feature does not require substantiation for charges below a specified dollar amount. Again, the CCA clarified that this fails to meet substantiation requirements and included a citation to a proposed regulation requiring substantiation for all claims, regardless of the amount.
- **Favored providers.** A health FSA with a debit card feature requires no substantiation for charges from certain dentists, doctors, hospitals, or other health care providers. The CCA emphasized that all claims must be substantiated.
- **Advance substantiation for dependent care FSA.** A dependent care FSA automatically reimburses employees for dependent care expenses when the employee has previously indicated such expenses would be incurred and the employee has not affirmatively notified the plan sponsor that such expenses were, in fact, incurred. The CCA makes clear that claims made in advance, without additional verification, do not meet substantiation requirements. It also notes the proposed regulations prohibit reimbursement of dependent care expenses before they have been incurred (i.e., merely formally being billed, or prepaying, is not sufficient) and without substantiating that they have been incurred.

■ Employer Action

While the substantiation requirements are not new, this is a good opportunity for employers to discuss and review substantiation procedures with FSA administrators, to ensure they are requiring full and proper substantiation of all claims for reimbursement, in keeping with existing guidance.