

LEGAL UPDATE



HIGHLIGHTS

- The IRS issued a memorandum on FSAs that provides helpful reminders about the strict substantiation requirements for these accounts.
- FSA expenses are not considered properly substantiated if employees self-certify expenses, if the plan uses sampling, if only amounts over a certain level are substantiated or if charges from favored providers are not substantiated.
- Dependent care expenses must be incurred before they are eligible for reimbursement.

IRS Addresses Claims Substantiation Requirement for FSAs

The IRS recently issued a [Chief Counsel Advice Memorandum](#) that provides important reminders about the claims substantiation requirements for flexible spending accounts (FSAs). These requirements apply to FSAs that reimburse medical expenses (health FSAs) and FSAs that reimburse dependent care expenses (dependent care FSAs).

Substantiation Requirements

Most FSAs are offered under a Section 125 cafeteria plan to allow employees to make pre-tax contributions. Under federal tax rules, all claims for reimbursement from an FSA must be substantiated by information from a third party that is independent of the employee and the employee's spouse and dependents, such as an explanation of benefits (EOB) from an insurance company or a detailed receipt from a medical or dependent care provider.

Many FSAs use debit cards to make it easier for participants to access their funds. Certain electronic transactions qualify for automatic substantiation, which means that employees are not required to submit additional information following the transaction.

Compliance Reminders

According to the IRS memorandum, the following methods are not permissible for substantiating reimbursements of medical expenses from an FSA:

- Allowing employees to **self-substantiate expenses**;
- Requiring substantiation of only a **random sample** of unsubstantiated charges to the debit card (that is, charges that are not automatically substantiated);
- Not requiring substantiation for debit card charges that are **less than a specified dollar amount**; and
- Not requiring substantiation for debit card charges **from certain dentists, doctors, hospitals or other favored health care providers**.

In addition, dependent care expenses may not be reimbursed before the expenses are incurred. Dependent care expenses are incurred when the care is provided and not when the employee is formally billed or charged for (or pays for) the dependent care.

Tax Consequences

Reimbursements from FSAs that are not fully substantiated must be included in the employee's gross income. Also, if a Section 125 cafeteria plan does not comply with the substantiation requirements for FSAs, the plan will no longer qualify for favorable tax benefits. To avoid these negative tax consequences, employers with FSAs should review their substantiation procedures to make sure they comply with IRS rules.