

July 14, 2006

MEMORANDUM TO CLIENTS

RE: IRS Expands Use of Debit/Credit Card Technology for Health Plans and Dependent Care Assistance Programs

Treasury and the IRS have taken a positive step toward relaxing some of the cumbersome paper receipt substantiation requirements that apply when debit/credit cards are used with health flexible spending arrangements ("FSAs") and Health Reimbursement Arrangements ("HRAs"). In Notice 2006-69, issued on July 11, 2006, the IRS expanded the automatic substantiation rules of Revenue Ruling 2003-43 by adding three new methods for substantiating claimed medical expenses without the use of paper receipts—one of which is an "inventory information approval system" that will allow paperless debit/credit card purchases of over-the-counter drugs. The Notice also provides new guidance regarding the use debit/credit cards for dependent care assistance expenses.

A. Background - Revenue Ruling 2003-43

Revenue Ruling 2003-43 eliminated, for certain transactions, the requirement that a health FSA or HRA participant submit paper receipts to an employer or third-party administrator for review prior to reimbursement. Instead, if certain requirements are met, substantiation is automatic when an employee pays for medical expenses with a debit card or credit card. For example, the ruling permits automatic substantiation when (i) transactions match co-payments under the major medical plan of the cardholder ("co-payment match"), (ii) transactions are recurring and match previously approved claims ("recurring claims"), and (iii) transactions are verified by the employer at the time and point-of-sale through communication (either electronically or by telephone) between the merchant, service provider, or independent third party and the employer ("real-time substantiation"). Absent the satisfaction of these rules, debit/credit card transactions may still be processed and substantiated after-the-fact, but these charges are considered conditional and are required to be substantiated by a review of additional third-party information, such as merchant or service provider receipts.

B. New Guidance - Notice 2006-69 and Health Plans**1. Co-Payment Match**

Notice 2006-69 expands the "co-payment match" substantiation method to include matches of co-payment amounts that are not more than five times the dollar amount for a particular service. Specifically, co-payment amounts will be fully substantiated without the need for submission of a receipt or further review if the dollar amount of the co-payment equals an exact multiple of not more than five times the dollar amount of the co-payment for, among other services, pharmacy benefits or visits to the doctor's office. This rule also applies in the event a health plan has tiered co-payments for the same benefit. For example, if the co-payment for generic prescription drugs is \$5 and the co-payment for non-generic prescription drugs is \$10 and an employee purchases \$45 worth of generic and non-generic prescription drugs, the purchase will be automatically substantiated because the amount of the transaction is an exact match of a combination of the co-payments and the amount does not exceed five times the co-payment amounts. If the purchase was for \$60, then the transaction must be substantiated by paper receipts (discussed below).

In the event the dollar amount of the co-payment exceeds a multiple of five or more times the dollar amount for a specific service (or where the dollar amount of multiple co-payments for the same benefit exceed this dollar threshold), the transaction will be treated as a conditional charge that must be confirmed by submitting additional third-party information, such as merchant or service provider receipts describing the (i) service or sale, (ii) date of the service or sale, and (iii) amount. In addition, if the dollar amount of the co-payment charge is not: (i) an exact multiple of the co-payment or (ii) an exact match of a multiple or combination of different co-payments for a benefit in the case of multiple co-payments for the same benefit, the charge is treated as conditional and must be confirmed, regardless of whether the amount is less than five times the co-payment. For example, if the employee in the above example purchased non-generic prescription drugs and nonprescription medication for \$27, the purchase must be further substantiated with paper receipts because the amount of the purchase is not an exact match of a multiple or combination of the co-payments for generic and non-generic prescription drugs.

2. Real-Time Substantiation - Inventory Information Approval System

Notice 2006-69 also expands the “real-time substantiation” method by allowing employers to adopt a system under which a third-party card processor uses inventory control information (e.g., stock keeping units (“SKUs”)) to determine whether an expense qualifies as a medical expense under Code section 213(d) (this includes nonprescription medications). Under this system, the card processor compares the SKU for a particular transaction (e.g., purchase of a pharmacy benefit or a doctor’s office visit) against a pre-existing list of items that qualify as section 213(d) medical expenses. If the SKUs for the transaction match up and the full amount of the medical expense is covered under the FSA or HRA, the expense will be automatically substantiated. If the transaction is only partially approved, the employee is required to make up the difference out of his or her own funds. Employers that adopt the system are required to maintain records relating to the transaction. If the employer utilizes an automatic data processing system, the requirements of Revenue Procedure 98-25 must be satisfied.

Employers adopting an inventory information approval system may permit merchants or service providers that do not maintain Merchant Category Codes (“MCCs”) (as required under Revenue Ruling 2003-43) to participate in the system. In this regard, specific merchants or service providers may become part of the employer’s “network” and contractually agree to only accept the debit/credit card for qualifying medical expenses. For example, if the participating merchant or service provider determines that only a portion of an expense qualifies as section 213(d) medical expense or the expense does not qualify as a medical expense at all, the merchant or service provider would deny reimbursement and request additional payment from the employee for the unpaid amount. If an employee attempts to use the debit card at a merchant or service provider that is not part of the network, reimbursements would also be denied.

3. Co-Insurance and Expenses Below a Plan’s Deductible

The Notice allows automatic substantiation of co-insurance or expenses that are below a plan’s deductible amount if an employer is furnished with, for example, an explanation of benefits (“EOB”) from an insurance company with certain information regarding the expense. This information must provide (i) that the expense was incurred, (ii) the date it was incurred, and (iii) the amount of the expense. For example, if an employer sponsoring a health plan coordinated with the plan’s insurer to automatically provide an EOB (with the above information) to the employer or a third-party administrator upon a participant’s doctor’s visit indicating that an employee was responsible for a

portion of an expense (e.g., 20% of \$150 for the doctor's visit), the expense would be automatically substantiated.

4. Prohibition Against "Self-Substantiation" or "Self-Certification"

The Notice explicitly prohibits "self-substantiation" or "self-certification" of a medical expense by a participant of a health plan. Therefore, an independent third-party (e.g., an insurance company, merchant, or service provider) must provide information regarding the expense under the methods set forth in Revenue Ruling 2003-43 or Notice 2006-69 in order for such expense to be substantiated and reimbursed.

C. New Guidance - Notice 2006-69 and Dependent Care Assistance Programs

For the first time, Treasury and the Service have formally provided that debit/credit cards may be used to automatically substantiate dependent care assistance expenses under a dependent care assistance program ("DCAP") or dependent care FSA provided certain requirements are met. Consistent with the current rules regarding when dependent care assistance expenses may be reimbursed, the Notice provides that dependent care assistance expenses may not be substantiated and reimbursed through a debit/credit card until the dependent care services are actually provided. Thus, if a dependent care provider requires payment before the dependent care services are provided, those expenses cannot be reimbursed at the time of payment, even through the use of a debit/credit card. As a result, the debit/credit card program for a DCAP or dependent care FSA must require an "initial substantiation" of dependent care assistance expenses before a participant may receive reimbursements for "subsequent" dependent care assistance expenses.

1. Initial Substantiation

Under this new debit/credit card program, an employee would pay initial expenses to a dependent care provider and submit a statement from the dependent care provider substantiating the dates and amounts for the services to the employer or plan administrator. Once this initial substantiation is made, the employer would set aside an amount for use under the program equal to the lesser of (i) the previously incurred and substantiated expense(s) or (ii) the employee's current salary reduction amount. These amounts may be used to reimburse subsequent dependent care assistance expenses after the dependent care services are provided (discussed below). For example, if a daycare center requires advance payment of \$250 for services each week, a participant who pays the initial \$250 cannot be reimbursed for this expense until after services have been provided. In this regard, until the participant submits a statement from the daycare center with a description of the (i) services, (ii) amount of the services, and (iii) date of the services, the participant's debit/credit card balance will be zero. Once this initial substantiation is received by the employer or plan administrator, the participant's balance will be increased by the lesser of (i) the participant's current salary reduction amount or (ii) the incurred expense so the participant may be reimbursed for subsequent expenses.

2. Subsequent Expenses

The substantiation and reimbursement of subsequent dependent care assistance expenses will be similar to the "recurring claims" substantiation method set forth under Revenue Ruling 2003-43. Specifically, expenses for transactions that have been previously approved would be automatically substantiated so long as the expense is equal to or less than the previously substantiated amount. If the

expense is greater than the previously substantiated amount, then similar to the initial substantiation of an expense (discussed above), an employee would be required to submit a statement or receipt from the dependent care provider before the expense could be substantiated and reimbursed under the debit/credit card program. For example, if the participant reduced her annual salary by \$5,000, the salary reduction amount available each week would be \$96.15. After the daycare services were provided and after these expenses were initially substantiated, such expenses would be automatically substantiated at the end each week so long as the expense was equal to or less than \$96.15 (i.e., the previously substantiated amount). If the expense exceeded \$96.15, the participant would be required to submit a statement or receipt detailing the expense.

D. Conclusion

The supplemental guidance for automatic substantiation of medical expenses set forth in Notice 2006-69 should be welcome news for the health care industry, employers, and employees. There are still many situations in which paper receipt substantiation is required, but it appears that, as debit/credit card technology continues to evolve, Treasury/IRS is willing to update its guidance. In addition, confirmation that debit/credit cards can be used to substantiate dependent care assistance expenses is helpful and should be well-received by those employers that offer dependent care FSAs and third-parties that administer such arrangements.

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Please contact Chris Keller or Chris Condeluci at (202) 857-0620 with any questions about the Notice or the use of debit/credit cards.

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