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IRS clarifies rules for correcting improper payments from health FSAs

The IRS Office of Chief Counsel has issued a memorandum that provides helpful guidance on the procedures an employer may use to correct health FSA payments made for ineligible expenses or expenses that are not properly substantiated. The memorandum also addresses how an employer should report improper payments that have not been corrected after other correction procedures have been exhausted.

Background

A health flexible spending arrangement (health FSA) is a self-insured group health plan that pays or reimburses the qualified medical expenses of an employee and his or her spouse and dependents. A health FSA is a qualified benefit that can be offered to employees under a cafeteria plan. The proposed section 125 regulations set out the requirements for health FSAs, including the conditions that must be met in order for an expense to be eligible for reimbursement. (See our [August 24, 2007 For Your Information](#).) The conditions include the requirement that the expense qualify as a health FSA-eligible expense, that it be incurred during the applicable coverage period, and that it be properly substantiated. In addition, the employee must certify that the expense has not been reimbursed and that reimbursement of the expense will not be sought from any other health plan coverage. Reimbursements that do not satisfy the requirements of the proposed regulations because they are for ineligible expenses or are not properly substantiated or certified are considered “improper payments.”



The proposed cafeteria plan regulations set out the following specific correction procedures that an employer must apply to correct improper payments made from a health FSA that involve the use of a debit card:

- Deny access to the card. Until the amount of the improper payment is recovered, the debit card is deactivated, and the employee must request payments or reimbursements of medical expenses from the health FSA through other methods (for example, by submitting receipts or invoices from a merchant or service provider showing the employee incurred a qualified medical expense).
- Require repayment. The employer demands that the participant repay the improper payment.

- **Withhold from pay.** If the demand for repayment is unsuccessful, the employer withholds the amount of the improper payment from the employee's pay or other compensation, to the full extent allowed by applicable law.
- **Offset.** If any portion of the improper payment remains outstanding after attempts to recover the amount are made as described above, the employer applies a claims substitution or offset to resolve improper payments, such as reducing the amount paid for a substantiated expense by the amount of the improper payment.
- **Treat payment as other business indebtedness.** If, after applying all the above procedures, the employee remains indebted to the employer for improper payments, the employer, consistent with its business practice, treats the improper payment as it would any other business indebtedness.

There was some question whether an employer had to apply these correction procedures in the order they appeared in the regulations and whether the procedures could also be used to correct improper payments that did not involve a debit card. In addition, employers were uncertain about how they were to report improper payments that were "forgiven" under their normal business practices.

Memorandum 2014130006

The Office of Chief Counsel recently issued a [memorandum](#) that addresses these issues.

Order and timing of correction procedures. Once the debit card is deactivated, the correction procedures generally may be applied in any order, as long as application is consistent for all participants. However, forgiveness of improper payments as uncollectible business debts is generally permitted only after the other correction methods have been pursued. The correction methods should be applied during the plan year in which the improper payment was made. The memorandum also states that a third party administrator may apply the procedures on behalf of the employer.

Application of procedures to health FSA improper payments not involving a debit card. The correction procedures for debit cards (i.e., request repayment, withhold from compensation, offset, and treat as a business debt) can be used for all health FSA improper payments, even where a debit card is not involved.

Reporting of forgiven improper payments. If application of the correction methods do not result in recovery of the improper payment by the end of the plan year, and the employer treats the improper payment as a business indebtedness, the employer must report the amount as wages on a Form W-2 to the extent that it forgives the indebtedness after requesting payment under its normal procedures for collecting business debts. The improper payment is reportable for the taxable year in which the debt is forgiven and the amount included in income is subject to income tax withholding, FICA, and FUTA.

Buck comment. An employer cannot simply choose to "forgive" the improper payment. If it typically pursues legal action to recover other business debts above a certain dollar threshold as part of its business practice, it may have to similarly take legal action if the amount of improper payment exceeds that threshold.

In closing

Historically, the IRS has been reluctant to address any area of cafeteria plan mistakes and correction procedures either formally or informally. Although the memorandum cannot be used or cited as precedent, it does provide insight into the IRS' legal position and provides a welcome clarification on how to correct improper payments from a health FSA.

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