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A Chief Counsel Advice memorandum addressed the proper correction methods for improper health FSA payments. This is informal guidance only (i.e., it cannot be cited as precedent), but it provides helpful insight.

### Background

Proposed Treasury Reg. § 1.125-5(a)(1) and (b) provide that after an expense for a qualified benefit has been incurred in a flexible spending arrangement, the expense must first be substantiated before the expense is reimbursed. The proposed regulation provides rules for substantiation of expenses that must be satisfied before paying or reimbursing any expense for a qualified benefit. Proposed Treasury Reg. §1.125-6(d)(7) provides the following correction procedures for any improper payments using a debit card:

1. Until the amount of the improper payment is recovered, the debit card must be deactivated and the employee must request payments or reimbursements of medical expenses from the health FSA through other methods (e.g., by submitting receipts or invoices from a merchant or service provider showing the employee incurred a Code Sec. 213(d) medical expense).
2. The employer demands that the employee repay the cafeteria plan an amount equal to the improper payment.
3. If, after the demand for repayment of improper payment as described in step 2, the employee fails to repay the amount of the improper charge, the employer withholds the amount of the improper charge from the employee's pay or other compensation, to the full extent allowed by applicable law.
4. If any portion of the improper payment remains outstanding after attempts to recover the amount (steps 2-3), the employer applies a claims substitution or offset to resolve improper payments such as a reimbursement for a later substantiated expense claim reduced by the amount of the improper payment. So, for example, if an employee has received an improper payment of \$200 and subsequently submits a substantiated claim for \$250 incurred during the same coverage period, a reimbursement for \$50 is made.

5. If, after applying all the above steps, 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.

An improper payment includes a payment that is not properly substantiated as well as a reimbursement of an expense that is later identified as not a qualified expense.

## Guidance

The memorandum addressed the following questions:

**Question:** Can the above correction procedures for debit cards be applied to other improper payments from a health FSA?

**Answer:** Yes; steps 2-5 can be used.

**Question:** Can an employer alter the order of correction procedures?

**Answer:** Yes, but the order must be consistently applied for all participants in the employer's health FSA and the employer may apply step 5 only after all correction methods in subsections 2-4 have been pursued. Forgiveness of improper payments as uncollectible business indebtedness should be the exception rather than a routine process. Repeated inclusion in income of improper payments suggests that proper substantiation procedures are not in place or that the payments may be a method of cashing out unused FSA amounts.

The correction methods in steps 2-4 should be applied during the period of coverage (the plan year) in which the improper payment was made to the participant. To the extent a participant repays the amount of an improper payment, the amount is available for reimbursing other claims incurred in the plan year or, if the plan has adopted a carry-over, available for claims included in the next plan year. In cases in which steps 2-4 were not applied during the period of coverage during which the improper payment was made to the employee, the employer should apply step 5 in accordance with Q&A 3 below.

Taking prompt action to correct improper payments will increase the likelihood of being able to use correction methods other than treating the payment as uncollectible.

**Question:** In cases in which all other correction procedures have been exhausted and the employer treats the improper payment as business indebtedness, is the amount of a forgiven improper payment reported by the employer to the employee on Form W-2 or Form 1099?

**Answer:** Form W-2, even if the employee no longer works for the employer. The amount included in income is subject to withholding for income tax, FICA and FUTA, since the benefits are made available to the employee by the employer for the performance of services. The improper payment is reportable in the taxable year of the employee in which the indebtedness is forgiven.