ACA, HIPAA AND FEDERAL HEALTH BENEFIT MANDATES:

PRACTICAL Q&A

The Affordable Care Act (ACA), the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and other federal health benefit mandates (e.g., the Mental Health Parity Act, the Newborns and Mothers Health Protection Act, and the Women's Health and Cancer Rights Act) dramatically impact the administration of self-insured health plans. This monthly column provides practical answers to administration questions and current guidance on ACA, HIPAA and other federal benefit mandates.

Attorneys John R. Hickman, Ashley Gillihan, Steven Mindy, Carolyn Smith, Ken Johnson, Amy Heppner, and Laurie Kirkwood provide the answers in this column. John is partner in charge of the Health Benefits Practice with Alston & Bird, LLP, an Atlanta, New York, Los Angeles, Charlotte, Dallas and Washington, D.C. law firm. Ashley and Steven are partners in the practice, and Carolyn, Ken, Amy, and Laurie are senior members in the Health Benefits Practice. Answers are provided as general guidance on the subjects covered in the question and are not provided as legal advice to the questioner's situation. Any legal issues should be reviewed by your legal counsel to apply the law to the particular facts of your situation. Readers are encouraged to send questions by E-MAIL to John at john.hickman@alston.com.

The IRS recently released internal guidance from its Office of Chief Counsel to the head of its employment tax policy division that reiterates and emphasizes the potentially severe consequences of taking shortcuts when substantiating flexible spending account claims (IRS Chief Counsel Advice 202317020, March 29, 2023, released April 28, 2023.

Employers, TPAs, and card processors must ensure that they follow the IRS substantiation rules as written without administrative shortcuts like sampling, de minimis thresholds, or other methods that do not satisfy the IRS substantiation guidelines set forth in the IRS Notices and proposed regulations. Otherwise, FSA plans risk disqualification of the entire cafeteria plan.

As the IRS memo makes clear, if the cafeteria plan is disqualified then all non-taxable benefits any employee receives through the employer's cafeteria plan must be included in gross income and are wages subject to withholding for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes.

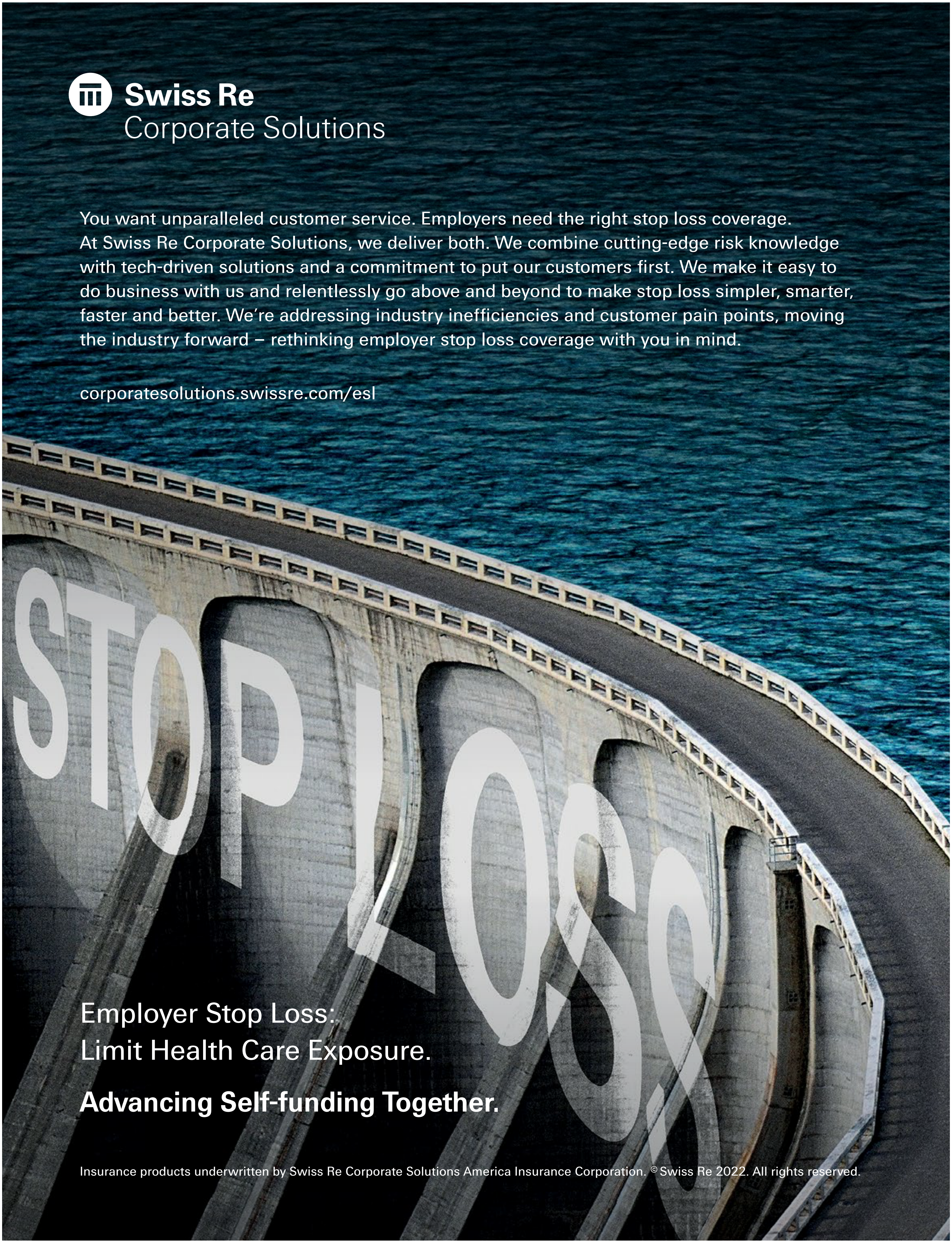
In other words, the consequences of failing to adhere to the IRS guidelines extend to defeat all tax advantages employers and employees receive via a cafeteria plan and are not limited to the improperly adjudicated claims.

The IRS memo does not break new ground or add any new rules. The IRS' Office of the Chief Counsel prepared it for the IRS' head of employment tax policy.

It's unlikely the IRS will make an official statement about what prompted the memo, but the memo indicates that the IRS does not agree with interpretations that the Internal Revenue Code ("Code") or IRS guidance allow certain substantiation practices that have been become more common for reasons such as administrative convenience or cost reduction.

The IRS' memo provides five examples of impermissible substantiation practices, but the IRS's position is not limited to these five examples and likely extends to additional methods that do not adhere to IRS guidance:

1. **Self-certification** -The IRS memo notes that all claims must be substantiated under the Code and IRS guidance. Accordingly, self-certification of claims that are not otherwise substantiated does not fulfill the requirement that every FSA claim must be substantiated by information from a third-party party that is independent of the employee and their spouse and dependents (Notice 2006-69). The IRS memo notes that its prior guidance prohibits self-substantiation of medical expenses (Prop. Reg. § 1.125-6(b)(3)). As a result, the cafeteria plan is disqualified if it only requires an employee to submit information describing the service or product, the date of sale or service, and the amount, but does not also require a statement from an independent third party to verify the expense.
2. **Sampling** – A cafeteria plan is disqualified if it reimburses all debit card charges but requires the employee to substantiate with third-party information a random sample of debit card charges that were not otherwise auto-substantiated under IRS rules. The IRS notes that its guidance requires substantiation of all claims (either manually or in accordance with IRS auto-adjudication guidance) and prohibits the use of sampling techniques (Prop. Reg. § 1.125-6(b); Rev. Rul. 2003-43).
3. **De minimis thresholds** – A cafeteria plan is disqualified if it does not require substantiation of all debit card charges (either manually or in accordance with IRS auto-adjudication guidance) regardless of how small the expense is. Plans must limit reimbursement and claims payment to medical expenses substantiated with third-party information that describes the service or product and includes the date of the service or sale (which the IRS notes includes expenses that are auto-substantiated consistent with IRS guidance) (Prop. Reg. §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1.125-6(b); Notice 2006-69; Notice 2003-43).

4. **Favored providers** – A cafeteria plan is disqualified if it does not require employees to substantiate debit card charges (either manually or in accordance with IRS auto-adjudication guidance) even though they may be incurred at certain providers whose expenses almost always qualify (e.g., dentists, doctors, hospitals, or other health care providers). As in the other examples, the plan must require substantiation of all claims (including via IRS approved auto-adjudication methods) and plans cannot exclude claims incurred at specific providers or facilities from their substantiation requirements. Note that real time adjudication or EOB rollover procedures for such providers are still allowable as long as they satisfy existing IRS guidance.
5. **Advance Dependent Care Assistance Claims** – A cafeteria plan is disqualified if it pays or reimburses an employee's dependent care expenses by submitting a form before receiving the dependent care that attests to the amount of dependent care expenses they will incur in the upcoming year. A plan cannot cure this by requiring employees to provide an after-the fact notice if their dependent care situation changes and they will not incur the qualified dependent care expenses to which they attested. The IRS reiterates that dependent care expenses paid by debit card must be substantiated with a statement from the dependent care provider that includes the dates and amounts for dependent care services provided (Prop. Reg. § 1.125-6(g)). Additionally, the IRS reminds plans that dependent care expenses cannot be reimbursed before the expense is incurred (Prop. Reg. § 1.125-6(a)(4)). A dependent care expense is incurred when the care is provided and not when the employee is formally billed, charged, or pays for dependent care.

As for consequences, the IRS says that employers sponsoring health FSAs that use the methods described in the first four examples must include all reimbursements by the health FSA during the year in the gross income of employees, including claims that were substantiated consistent with IRS guidance.

The IRS adds that an employer providing the advance reimbursement of dependent care expenses must include all payments under the dependent care assistance plan in the gross income of employees and wages of employees for FICA and FUTA tax purposes.

Perhaps even more significantly for employers, the IRS adds that its flexible spending accounts' failure to follow the substantiation requirements in Prop. Reg. § 1.125-6(b) is also a failure to operate in accordance with the written plan or a failure to operate in accordance with Code § 125 and § Prop. Reg. § 1.125-1(c)(7)(ii)(G).

This supports the IRS' position that the entire cafeteria plan is disqualified by substantiation failures and the tax consequences are not limited to the flexible spending accounts. Thus, even employees who do not make an FSA election will lose the pre-tax advantages under the employer's cafeteria plan.

In addition to the amounts that an employer must add to income and wages if its cafeteria plan is disqualified, the employer also becomes liable for applicable penalties and interest payable to the IRS for reporting and withholding errors and might need to amend its prior returns and reports, including employees' W-2s.

In other words, the consequences are potentially far reaching and could reverberate across an employer and its workforce when a flexible spending account uses substantiation methods that the IRS has not adopted in its guidance. ■