

Employee Benefits Briefing

A bulletin designed to keep clients and other friends informed on employee benefits law matters

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FLEXIBLE SPENDING ACCOUNTS — RECENT DEVELOPMENTS

Several significant rulings have been issued the last six months affecting the operation of flexible spending accounts (FSAs). These rulings address the use of debit cards with health FSAs, HIPAA privacy rule coverage, and health FSA reimbursement of laser vision correction surgery, nonprescription drugs and other services and supplies.

Debit Cards for Health FSAs

The IRS recently provided guidance on the use of debit cards with health FSAs. Using debit cards to reimburse medical expenses can reduce participants' cash-flow concerns because they no longer have to prepay and then wait for reimbursement. In Revenue Ruling 2003-43, the IRS concluded that the use of debit cards is allowable provided the plan administrator substantiates expenses as eligible health care expenses.

The Ruling provides that every claim must be substantiated using either an automatic or a manual procedure. The IRS approved plan procedures that treated three categories of transactions as being automatically substantiated: co-payment transactions, recurring transactions and real-time transactions. Transactions that fit within one of these three categories require no further substantiation. For those transactions that are not automatically substantiated, additional manual substantiation is required.

Manual procedures require all transactions to be treated as conditional pending confirmation of the charge. Therefore, after the purchase, the participant

must submit additional information, such as merchant or service provider receipts, describing the service or product purchased and the date and amount of the sale. This information may be submitted electronically, manually or a combination of both, according to the IRS.

The Ruling also appears to require an employer using a debit card program for health FSAs to: (1) amend the governing plan documents to incorporate provisions outlining the debit card program; (2) develop recovery procedures in the event a charge is allowed that is later determined to be impermissible; (3) require a certification by participants upon enrollment and with each use of the debit card, as printed on the back of the card, that the card will only be used for medical expenses; and (4) limit use to certain merchants or service providers authorized by the employer and to specified merchant codes relating to health care.

The Ruling concludes by stating that payments of \$600 or more in a year to a medical service provider are reportable on Form 1099-MISC. This requirement apparently applies to all health FSAs and may require a change in current procedures.

FSAs Are Covered by HIPAA

Health FSAs are "covered entities" subject to the HIPAA Privacy Rule, according to the Department of Health and Human Services (HHS), the agency charged with enforcement of HIPAA's Privacy Rule. HHS concluded that because the benefits provided under health FSAs include payment for medical care, they are

considered group health plans and must comply with the HIPAA Privacy Rule unless they have fewer than 50 participants and are self-administered.

Therefore, even employers with fully insured health plans who do not otherwise use protected health information must now comply with the Privacy Rule in the same manner that they would for other self-insured plans with respect to their FSAs, provided the employer has at least 50 employees participating in the health FSA.

Compliance with the HIPAA Privacy Rule includes amendment of plan documents, drafting and communicating a notice of privacy rights, entering into business associate contracts with third-party administrators and implementing policies and procedures to protect personal health information. Plans that have less than \$5,000,000 in annual gross receipts have until April 14, 2004 to comply.

Additional Guidance Regarding Reimbursable Expenses

Several recent rulings clarify whether certain costs are reimbursable expenses under a health FSA.

In one ruling, the IRS looked at three procedures that might be viewed as “cosmetic” and therefore not reimbursable:

- (1) breast reconstruction surgery,
- (2) vision correction surgery; and
- (3) teeth whitening.

In each case, the IRS focused on Internal Revenue Code section 213, which defines medical expenses. Under that Code section, if a procedure simply improves appearance and does not improve proper function of the body or treat or prevent illness or disease, then it is cosmetic and not medical in nature. Breast reconstruction and laser eye surgery, the IRS concluded, generally either correct deformity or promote the proper function of the body. Therefore, both procedures are

reimbursable. In contrast, the IRS concluded that teeth whitening procedures to correct discoloration due to aging is not a reimbursable medical expense, as it neither treats a disease nor promotes the proper function of the body.

In a separate ruling, the IRS examined whether (1) nonprescription medicines and (2) nonprescription equipment, supplies or diagnostic devices are medical expenses under Code section 213, if they are recommended by a doctor. The IRS concluded that nonprescription drugs recommended by a doctor, such as aspirin, are not reimbursable through a health FSA. On the other hand, items such as crutches and bandages mitigate the effects of an injury and blood sugar test kits that assist in the treatment of diabetes are medical expenses under Code section 213 and are reimbursable through the health FSA.

Finally, the IRS considered whether certain fees and expenses incurred in obtaining donated eggs for in vitro fertilization are deductible medical expenses. The IRS concluded that expenses paid by the taxpayer to obtain an egg from donor, including the donor’s expenses, would be directly related and preparatory to the taxpayer’s receiving the egg and would generally be deductible as medical expenses. Implicit in the IRS ruling is the conclusion that such expenses would be reimbursed through a health FSA.

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