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memorandum

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to: Joseph Tiberio, Manager
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from: Harry Beker, Chief
(Health and Welfare Branch)
CC:TEGE:EB:HW

subject: Correction Procedures For Improper Health Flexible Spending Arrangement Payments

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

(1) Whether the correction procedures for debit cards provided in the proposed cafeteria plan regulations may be applied to improper payments from a health flexible spending arrangements (health FSA).

(2) Whether an employer may alter the order of correction procedures provided in the proposed cafeteria plans regulations.

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

LAW AND ANALYSIS

Section 61(a)(1) and § 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106 provides that "gross income of an employee does not include employer-provided coverage under an accident or health plan." Section 1.106-1 provides that the gross income of an employee does not include contributions which the employee's employer makes to an accident or health plan for compensation (through insurance or otherwise) for personal injuries or sickness to the employee or the employee's spouse or dependents (as defined in § 152).

Section 105(a) provides that "amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer."

Section 105(e) states that amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance for purposes of § 105. Section 1.105-5(a) provides that an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. Thus, amounts that are paid to an employee regardless of whether the employee incurs expenses for medical care or suffers a personal injury or sickness are not received under an accident or health plan.

Section 105(b) states that, except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical expenses) for any prior taxable year, gross income does not include amounts referred to in § 105(a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by the taxpayer for the medical care (as defined in § 213(d)) of the taxpayer or the taxpayer's spouse or dependents (as defined in § 152) and any child (as defined in §152(f)(1) of the taxpayer who as of the end of the taxable year has not attained age 27.

Section 1.105-2 provides that only amounts that are paid specifically to reimburse the taxpayer for expenses incurred by the taxpayer for the prescribed medical care are excludable from gross income. Section 105(b) does not apply to amounts that the taxpayer would be entitled to receive irrespective of whether or not the taxpayer incurs expenses for medical care.

Under § 125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to § 125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it was available to the employee and the employee could have chosen to receive cash instead.

Section 125(d)(2)(A) and Proposed Treasury Reg. § 1.125-1(o)[1] generally provide that a cafeteria plan does not include any plan which provides for deferred compensation.

To the extent amounts are excluded from gross income under §§105(b) and 106(a), they are also excluded from income tax withholding under §3401. In addition, amounts paid to reimburse expenses incurred are excluded from FICA and FUTA taxes under §§3121(a) and 3306(b).

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. Proposed Treasury Reg. §1.125-6(b) 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.

(i) Until the amount of the improper payment is recovered, the debit card must be de-activated 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 section 213(d) medical expense);

(ii) The employer demands that the employee repay the cafeteria plan an amount equal to the improper payment;

(iii) If, after the demand for repayment of improper payment (as described in Proposed Treasury Reg. §1.125-6(d)(7)(ii)), 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;

(iv) If any portion of the improper payment remains outstanding after attempts to recover the amount (Proposed Treasury Reg. §1.125-6(d)(7)(ii) and (iii)), the employer applies a claims substitution or offset to resolve improper payments, such as a reimbursement for a later substantiated expense claim is 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; and

(v) If, after applying all the procedures described in Proposed Treasury Reg. §1.125-6 (d)(7)(ii) through (iv), the employee remains indebted to the employer for improper

[1] Taxpayer may rely on the proposed regulations under section 125 (§§ 1.125-1, -2, -5, -6 and -7) for guidance pending the issuance of final regulations, as provided in the preamble to the proposed regulations (72 Federal Register 43938, 43944).

payments, the employer, consistent with its business practice, treats the improper payment as it would any other business indebtedness.

For this purpose, 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.

ISSUE 1

The correction procedures for debit card payments provided in Proposed Treasury Reg. §1.125-6(d)(7)(ii) through (v) may be applied to improper payments under a health FSA.

The employer is the sponsor of the health FSA and is responsible for complying with the rules provided under the Code and regulations. A third-party administrator may apply the overpayment correction procedures on behalf of the employer.

ISSUE 2

The employer may apply the rules of Proposed Treasury Reg. §1.125-6(d)(7)(ii) through (iv) in any order but the order must be consistently applied for all participants in the employer's health FSA. However, the employer may apply the correction method in subsection (v) only after all correction methods in subsections (ii) through (iv) have been pursued by the employer. 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.

Section 125(d)(2)(A) and Proposed Treasury Reg. §1.125-1(o) generally provide that a cafeteria plan does not include any plan which provides for deferred compensation.

Thus, the correction methods in Proposed Treasury Reg. 1.125-6(d)(7)(ii) through (iv) 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 pursuant to Notice 2013-71, available for claims included in the next plan year (subject to the limitations of Notice 2013-71.)

In cases in which the correction methods in Proposed Treasury Reg. §1.125-6(d)(7)(ii) through (iv) were not applied during the period of coverage during which the improper

payment was made to the employee, the employer should apply Proposed Treasury Reg. §1.125-6(d)(v) in accordance with Issue 3 below.

ISSUE 3

In cases in which all other correction procedures have been exhausted by the employer and the employer treats the improper payment as business indebtedness in accordance with Prop. Treasury Reg. §1.125-6(d)(7)(v), the improper payment should be reported by the employer to the employee as wages on a Form W-2 to the extent the employer forgives the indebtedness after requesting payment consistent with collection procedures for other business indebtedness. 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.

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Please call (202) 317-5500 if you have any further questions.