EM Connections

Euclid Managers Compliance Resources

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IRS Reminds Plan Sponsors of Cafeteria Plan Claims Substantiation Requirements

The federal Section 125 “cafeteria plan" regulations permit health plans to reimburse participants for qualifying medical and dependent care expenses on a pre-tax basis through health flexible spending accounts (FSAs) and dependent care assistance plans (DCAPs) if those claims are properly and fully substantiated. If claims are improperly substantiated, any contributions participants make into these reimbursement accounts can lose their tax-favored status and may instead become subject to taxation as gross income for participants.

Two items are required to substantiate health FSA and DCAP claims for reimbursement: (1) information, such as a receipt or bill, from a third party independent from the employee, the employee’s spouse, and the employee’s dependents (e.g., the party that provided the care) describing the service/product provided, the date of the service/sale, and the amount of the expense and (2) a statement from the participant explaining that the expense has not yet been reimbursed and that the participant will not also seek reimbursement for the same expense under another health plan. Claims cannot be reimbursed through FSAs or DCAPs prospectively—participants can only be reimbursed for expenses through these accounts after the expense has occurred and the care/service provided.

A recent memorandum from the Internal Revenue Service reminds employers of these requirements and reiterates procedures that do not qualify as full, complete claims substantiation. Specifically, the IRS emphasizes that:

- Every claim must be substantiated with information from an independent third party;
- Every claim must be fully substantiated, regardless of the amount of the claim and/or the provider;
- Adopting a policy of expense “sampling,” wherein a plan sponsor only substantiates a selection of claims incurred, is not compliant;
- Employees cannot self-certify expenses;
- Dependent care expenses cannot be reimbursed before they are incurred; and
- Improperly substantiated expenses must be included in participants’ gross income and will be subject to taxation.

Considering these recent reminders, we encourage plan sponsors to review their claims substantiation procedures and make any necessary adjustments to ensure they are following the existing regulations.