

## Publications

## IRS Explains FSA Substantiation Rules

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On April 28, 2023, the Internal Revenue Service (“IRS”) Office of Chief Counsel issued a [Chief Counsel Advice \(“CCA”\)](#) explaining the requirements for claim substantiation for health and dependent care flexible spending accounts (“FSAs”). Although the CCA only discusses FSAs, presumably, the IRS would apply these same rules to health reimbursement arrangements.

Specifically, the CCA provides that:

- Reimbursements are included in an employee’s gross income if the expenses are not fully substantiated, regardless of the amount of the expense.
- If a cafeteria plan does not require an independent third party to substantiate the expense, then the plan fails to operate in accordance with the proposed cafeteria plan regulations and the amount of benefits that employees elect under the cafeteria plan are includable in income as wages and subject to FICA and FUTA. Examples of impermissible practices are:
  - Self-certification;
  - “Sampling” of expenses;
  - Certification by favored providers;
  - No substantiation below a certain threshold; and
  - No substantiation of dependent care FSA expenses.

**GROOM INSIGHT:** A CCA is written advice that the Office of Chief Counsel National Office issues to the field office that conveys the Chief Counsel’s interpretation of the law. These rules are not new, so it is not clear why there was a need for the CCA at this time. The issuance of this CCA might signal that the IRS is beginning to educate auditors on the substantiation rules and the tax consequences of not complying with these rules.

The CCA provides six exemplary factual situations to illustrate the substantiation requirements.

## Situation 1 (Full Substantiation of Every Claim)

The plan only reimburses expenses “substantiated by information from a third party” with sufficient detail regarding the expense and requires that the participant give certifications that reimbursements have not been covered by other plans and that they will not seek reimbursement from other plans. This is compliant.

## Situation 2 (Self-Certification)

In addition to the facts in Situation 1, the plan allows reimbursement of expenses described in a specific manner by the participant, but without any third-party statement (either before or after). This is not compliant because the self-certification of claims “does not ensure that every claim be substantiated.”

## Situation 3 (Sampling)

In addition to the facts in Situation 1, the plan only substantiates a random sample of debit card claims via third-party information. This is not compliant because sampling “does not ensure that every claim be substantiated.”

## Situation 4 (De Minimis)

In addition to the facts in Situation 1, the plan does not require substantiation of debit card reimbursements below a specific threshold via third-party information. This is not compliant because allowing claims for reimbursement to be processed without substantiation if below a specific threshold “does not ensure that every claim be substantiated.”

GROOM INSIGHT: A frequently-asked question we receive is whether it is necessary to substantiate very small expenses, such as those in the \$5 or less range. Based on this and earlier IRS guidance, the answer from the IRS’ perspective is yes.

## Situation 5 (Favored Providers)

In addition to the facts in Situation 1, the plan does not require substantiation of debit card reimbursements that are charged to specific providers or hospital systems. This is not compliant because allowing claims for reimbursement to be processed without substantiation if the claims are for a specific provider “does not ensure that every claim be substantiated.”

## Situation 6 (Advance Substantiation for Dependent Care Assistance Programs)

The plan allows for reimbursement of dependent care based on estimates prior to incurring the care with no requirement for substantiation after the expenses are incurred. This is not compliant because it reimburses claims that have not been incurred or substantiated.

In Situations 2-6 above, the failure to comply with the substantiation requirements of the proposed cafeteria plan regulations results in the cafeteria plan’s failure to operate in accordance with its written plan or the failure to operate in accordance with Code section 125 and the proposed regulation.

GROOM INSIGHT: While the CCA is not binding and mostly reiterates the IRS’ prior positions, it signals that IRS may take a strict stance on the impermissible practices the CCA highlights. Thus, employers and administrators should review their processes to ensure that they are not engaging any of these practices.