



IRS Loosens, Then Tightens FSA Debit Card Rules

Well, there's no rest for the weary. Just at the time many of you are wrestling with late-year enrollment and payroll changes to accommodate last weekend's overhaul of the health savings account rules, here come IRS guidance on flexible spending account debit cards *and* final regulations on the HIPAA nondiscrimination rules, including wellness programs. We will deal with the HIPAA regulations in an *Alert* you'll see early next week. We take aim in *this Alert* on yesterday's announcement on debit cards.

To understand yesterday's announcement one must have a sense of prior debit card guidance. The IRS first dealt with debit cards in 2003. The Service approved the use of debit cards with respect to flexible spending accounts ("FSAs") and health reimbursement arrangements ("HRAs") but only where the cards were used at merchants and health care providers operating under *specific merchant category codes related to health care*. The 2003 ruling provided, "the card's use [must be] limited to physicians, pharmacies, dentists, vision care offices, hospitals and other medical care providers."

Thus, the ruling did *not* approve the use of debit cards at other merchants such as supermarkets or discount retail stores that might include a pharmacy and over-the-counter medicines and drugs. Those merchants would not be operating under health care-related merchant codes, of course, because their *primary* business was selling non-health care

items. In addition, the 2003 ruling prescribed a "pay and chase" requirement under which debit card transactions must be substantiated after the fact.

Last summer the IRS announced that FSA and HRA debit cards could also be used at other merchants and service providers—the same supermarkets and discount retail stores forsaken by the 2003 guidance—notwithstanding the fact they did not operate under health care-related merchant codes. But the cards could be used at such merchants only if the merchants had in place an "inventory information approval system" that allowed for clear delineation between health care-related items, which could be purchased with the debit card, and non-health care items, which could not.

"Uh-oh"

This summer's ruling seemed like welcome news. But judging from the unanticipated ruckus it triggered, a substantial number of FSA and HRA vendors must have already been allowing—under an overly broad interpretation of the 2003 guidance—what the IRS declared impermissible in the summer's guidance.

Apparently the ruckus was loud enough to reach Washington. Yesterday the IRS issued "transition relief"—a one-year reprieve—allowing all supermarkets, grocery stores, discount stores and wholesale clubs that do not operate under a health care-related merchant category code to be *treated as*

though they do, through 2007. Mail-order and web-based vendors selling prescription drugs get the same treatment. Transactions at all these merchants remain subject to the same “pay and chase,” after-the-fact substantiation requirement that applies to transactions at health care providers.

After 2007 a debit card may be used *only* at merchants operating under health care-related merchant codes *or* utilizing an appropriate inventory information approval system.

Now You’ve Gone Too Far

While the IRS relaxed the rules, albeit temporarily, for supermarkets and retail stores, it simultaneously tightened them for drug stores that sell a lot more than prescription drugs and health care supplies. Beginning in 2009, debit cards may no longer be used at drug stores—even if they operate under health care merchant codes—unless:

- At least 90 percent of the store’s gross receipts during the prior taxable year were attributable to the sale of items qualifying as “medical care,” or
- The store utilizes an inventory information approval system of the sort required of supermarkets and retail stores after 2007.

Maybe by 2009 there will be some way for drug stores to certify to FSA and HRA vendors that the stores meet the 90% test. But it seems more likely debit card issuers will instead require the drug stores to utilize an inventory information approval system.

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