

Can We Use a “Sampling” Approach to Reviewing Claims Under Our Health FSA and DCAP?

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QUESTION: Do we need to review every claim that is submitted under our cafeteria plan’s health FSA and DCAP before providing reimbursement? We do this now, but we could save time and administrative costs by automatically reimbursing claims for very small dollar amounts without review, or by reviewing only a sample of the claims incurred at medical or dependent care providers on the assumption that almost all of these claims are for eligible expenses.

ANSWER: Generally, under IRS rules, all health FSA and DCAP claims must be substantiated with information from an independent third party (i.e., a party independent of the employee and the employee’s spouse and dependents) describing the service or product, the date of the service or sale, and the amount of the expense. These requirements are designed to ensure that health FSAs and DCAPs reimburse only legitimate claims. (Other requirements also apply.) IRS rules regarding debit card programs also require that claims be substantiated and reviewed, although certain categories of expenses are treated as automatically substantiated without any receipts or review beyond the swipe.

Because all claims are subject to the claim substantiation requirements, administrators cannot engage in substantiation shortcuts such as reviewing only a percentage of claims (i.e., sampling) or automatically reimbursing claims that are below a “de minimis” dollar threshold or that appear to be from medical or dependent care providers. These actions jeopardize the income exclusion that would otherwise apply to reimbursements from these arrangements under the Code, and could cause all reimbursements to be taxable, not just those approved using the impermissible techniques. IRS rules also provide that if a health FSA or DCAP fails to comply with applicable substantiation requirements, all employees’ elections between taxable and nontaxable benefits under the entire cafeteria plan will result in gross income. A March 2023 IRS Chief Counsel’s office memorandum reconfirms the substantiation requirements for medical and dependent care expenses, as well as the prohibition and consequences of sampling and other substantiation shortcuts.

For more information, see EBIA’s Cafeteria Plans manual at Sections XX.J (“Health FSAs: Adequate Claims Substantiation Must Be Received From the Participant and an Independent Third Party”), XXI.G (“Electronic Payment Card Programs for Health FSAs”), and XXIV.M (“DCAPs: Adequate Claims Substantiation Must Be Received”).

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