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## Correcting Improper Health FSA Payments

A recent IRS memorandum provides guidance on correcting health flexible spending account (FSA) payments for expenses that are not properly substantiated or are later determined to be ineligible expenses.  The memorandum references guidance in a prior proposed regulation on debit card correction procedures for health FSAs, and provides that similar corrective actions are available to correct all errors in payment for any health FSA or dependent care FSA reimbursements, regardless of whether a debit card was used.

**Corrective Steps from Prior Guidance.** The prior guidance allowed for the following debit card correction procedures:

1. Deactivate the debit card until the amount of the improper payment is recovered (employee must request payments or reimbursements through other methods).
2. Demand that the employee repay the improper payment.
3. If the employee fails to repay, withhold the payment from compensation (to the extent allowed by law).
4. Apply a claims substitution or offset (e.g., employee with improper payment of $200 subsequently submits a substantiated claim for $250 incurred during the same coverage period, and a reimbursement for $50 is made).
5. If any portion remains outstanding after applying steps 1-4, treat the payment as any other business indebtedness (i.e., take same steps employer would take to collect an equivalent business debt).

**Corrective Steps – Recent Clarifications.** The recent IRS memorandum provides the following clarifying guidance regarding the five corrective action steps:

- For debit card errors in payment, the employer must deactivate (suspend) the debit card (step 1),  but can then use steps 2-4 in any order to correct the error.
- For non-debit card payment errors, the employer can use corrective steps 2-4 in any order.
- While the employer (as plan sponsor) is responsible for complying with the legal requirements, a TPA can apply the correction procedures on the employer's behalf.
- Correction steps 2–4 can be used in any order, as long as the order is consistently applied for all participants.
- Steps 2-4 should be applied in the plan year that the plan made the improper payment (repayments will be available for reimbursing other expenses incurred during the plan year, or for carryover if permitted under the plan).

Step 5 should be used only after exhausting 2-4 (treating an improper payment as uncollectible should be the exception, rather than a routine process).

- If step 2-4 is not applied in the plan year that the plan made the improper payment, the plan sponsor should use correction step 5 (taking prompt action to correct improper payments will increase the likelihood of being able to use correction methods other than treating the payment as uncollectible).
- If step 5 is used, the employer must first request payment consistent with its collection procedures for other business debts. If the payment is not recovered, the employer may forgive the indebtedness, in which case the improper payment should be reported as wages on the employee's Form W-2 for the year in which the indebtedness is forgiven. The reported amount is subject to withholding for income tax, FICA, and FUTA (according to previous informal IRS comments, Form W-2 should be used for this purpose even if the employee no longer works for the employer).

While this memorandum cannot be used or cited as precedent, it does provide helpful insight into the IRS's current thinking and is consistent with previous informal IRS comments regarding correction of health FSA reimbursement errors. Should you have questions regarding these rules or any other area of compliance, please contact your Conner Strong & Buckelew account representative. For a complete list of Legislative Updates issued by Conner Strong & Buckelew, please visit our online [Resource Center](#).