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memorandum**

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to: Jay Jensen
SB/SE Employment Tax Policy

from: Laura Warshawsky
Deputy Associate Chief Counsel (Employee Benefits)
CC:EEE:EB

subject: Claims Substantiation for Payment or Reimbursement of Medical and Dependent Care Expenses

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

- (1) Are reimbursements of section 213(d) medical expenses to an employee from a health flexible spending arrangement (health FSA) provided in a section 125 cafeteria plan included in an employee's gross income under section 105(b) if any section 213(d) medical expenses of any employee are not substantiated in accordance with proposed regulation § 1.125-6(b)?
- (2) Will expenses be considered properly substantiated if employees self-certify expenses, if the plan substantiates only some expenses "sampling", if only amounts over a certain level (i.e., de minimis amounts) are substantiated, if charges with favored providers are not required to be substantiated, or if dependent care expenses are reimbursed before the expenses are incurred?

CONCLUSION

Reimbursements of section 213(d) medical expenses to an employee from a health FSA provided in a section 125 cafeteria plan are included in the gross income of such

employee if any expense of any employee reimbursed by the health FSA is not fully substantiated including if any expenses below a certain threshold are not substantiated.

If a section 125 cafeteria plan does not require an independent third party to fully substantiate reimbursements for medical expenses (for example, by permitting self-certification of expenses, “sampling” of expenses, or certification by favored providers), does not require substantiation for medical expenses below certain dollar amounts, or does not substantiate reimbursements for dependent care assistance expenses, then the plan fails to operate in accordance with the substantiation requirements of Prop. Reg. § 1.125–6(b) and is not a cafeteria plan within the meaning of section 125. Therefore, the amount of any benefits that any employee elects under the cafeteria plan must be included in gross income and is wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes subject to withholding.

In addition, an employer may not exclude reimbursements of dependent care expenses from an employee’s gross income if any expenses of any employee under the dependent care assistance program are not substantiated after the expense has been incurred.¹

FACTS

Situation 1. An employer provides a section 125 cafeteria plan with a health FSA that reimburses section 213(d) medical expenses incurred by employees. The plan only reimburses section 213(d) medical expenses that are substantiated by information from a third party that is independent of the employee and the employee’s spouse and dependents. In addition, the information from the third party describes the service or product, the date of service or sale, and the amount of the expense.

In addition, the plan reimburses expenses based on information from an independent third party such as an “explanation of benefits” from an insurance company. The plan requires that information from the independent third party include (i) the date of the section 213(d) medical care, and (ii) the employee’s share of the cost of the medical care (that is, coinsurance payments and amounts below the deductible). The plan also requires the employee to certify that any expense paid by the plan has not been reimbursed by insurance or otherwise and that the employee will not seek reimbursement from any other plan covering health benefits.²

Lastly, the plan provides debit cards that can be used to reimburse section 213(d) medical expenses that meet the requirements of Prop. Reg. § 1.125-6 (c), (d), (e), and (f).

Situation 2. Self-certification. Instead of only reimbursing expenses that are substantiated as described in *Situation 1*, the plan also reimburses employees for

¹ See Prop. Reg. § 1.125–6(b)(2) and Notice 2006–69, 2006-31 IRB 107, 109.

² See Prop. Reg. § 1.125-6(b)(3)(ii).

medical expenses for which an employee only submits information describing the service or product, the date of service or sale, and the amount of the expenses, but does not provide a statement from an independent third party (either automatically or after the transaction) to verify the expenses. Further, the plan does not substantiate debit card charges (including charges that are not auto-substantiated³ expenses for recurring medical expenses incurred at certain providers that match the amount, medical care provider, and time period of previously approved expenses) with a statement from an independent third party.

Situation 3. Sampling. In addition to reimbursing expenses that are substantiated as described in *Situation 1*, the plan reimburses all charges to the debit card and only requires substantiation of a random sample of otherwise unsubstantiated charges to the debit card (that is, charges that are not auto-substantiated) through third-party information describing the service or product and the date of the service or sale.

Situation 4. De minimis. In addition to reimbursing expenses that are substantiated as described in *Situation 1* or expenses that are auto-substantiated, if a charge to the debit card is less than a specified dollar amount, the plan does not require substantiation of the charge to the debit card through additional third-party information describing the service or product and the date of the service or sale.

Situation 5. Favored providers. In addition to reimbursing expenses that are substantiated as described in *Situation 1* or expenses that are auto-substantiated, if a charge to the debit card is from certain dentists, doctors, hospitals or other health care providers, the plan does not require substantiation of the charge to the debit card through additional third-party information describing the service or product and the date of the service or sale.

Situation 6. Advance Substantiation for Dependent Care Assistance Program. An employer provides a section 125 cafeteria plan with a dependent care assistance program under section 129 that reimburses dependent care expenses incurred by employees. The plan allows employees to submit a form in advance of receiving the dependent care, attesting to the amount of dependent care expenses they will incur in the upcoming year. The plan requires employees to notify the plan sponsor if their dependent care situation changes and they will not incur the amount of qualified dependent care expenses to which they attested for that year. The employee is automatically reimbursed every pay period a pro rata amount of the amount of dependent care assistance expenses to which the employee attested.

³ The term auto-substantiated refers to medical expenses that may be approved without additional substantiation under Prop. Reg. § 1.125-6(e)(4) *Certain recurring medical expenses*. This method of substantiation allows a payment of a recurring expense that is for a medical expense incurred at certain providers that matches the amount, medical care provider, and time period of previously approved expenses to be automatically substantiated.

LAW AND ANALYSIS

Section 61(a)(1) of the Internal Revenue Code and Treas. Reg. § 1.61-21(a)(3) provide that, except as otherwise provided in subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

In general, under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness.

In general, under section 129, an employee may exclude amounts received through a dependent care assistance program if those amounts are paid to reimburse dependent care assistance expenses incurred by the employee. Section 129(e)(9) generally requires identifying information of the dependent care service provider to be included in the employee's tax return for the amounts to be excluded under section 129.

Sections 3101 and 3111 impose FICA taxes on "wages," as defined in section 3121(a), with respect to "employment," as that term is defined in section 3121(b). "Wages" is defined in section 3121(a) for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines the term "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

Section 3301 imposes FUTA taxes on wages paid with respect to employment. The general definitions of the terms "wages" and "employment" for FUTA tax purposes are similar to the definitions for FICA tax purposes. See section 3306(b) and (c).

Section 3402(a), relating to federal income tax withholding, generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term "wages" is defined in section 3401(a) for federal income tax withholding purposes as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Amounts excluded from gross income under section 105(b) are also excluded from wages subject to income tax withholding under section 3401. In addition, amounts paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness are excepted from wages for FICA and FUTA tax purposes under sections 3121(a)(2) and 3306(b)(2), respectively.

Section 3121(a)(5)(G) provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of section 125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if section 125 applied for purposes of section 3121) section 125 would not treat any wages as constructively received. Section 3306(b)(5)(G) contains a similar exception from wages for purposes of FUTA tax.

Treas. Reg. § 1.105-2 provides that the exclusion under section 105(b) does not apply to amounts a taxpayer would be entitled to receive whether or not the taxpayer incurs expenses for medical care.

Section 125 allows an employer to establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, in the form of salary reduction) and qualified benefits, including accident or health coverage. Section 125 provides that the amount an employee contributes to the plan on a pre-tax basis through salary reduction that is applied to purchase the coverage is not included in gross income, even though it is available to the employees and the employee could have chosen to receive cash instead. If an employee elects to participate in a health FSA on a pre-tax basis through salary reduction under a section 125 cafeteria plan, the value of the coverage by the health FSA is excludable from gross income under section 106 as employer-provided accident or health coverage, and the amounts reimbursed for section 213(d) medical expenses are excludable from gross income under section 105(b) as amounts reimbursed for section 213(d) medical expenses. If an employee elects to participate in a dependent care assistance program paid for through salary reduction under a section 125 cafeteria plan, the dependent care assistance program benefits are excludable from gross income under section 129.

Prop. Reg. § 1.125-1(c)(7)(ii)(G) provides that a failure to comply with the substantiation requirements of Prop. Reg. § 1.125-6 results in a failure of the cafeteria plan to operate in accordance with section 125 and the Proposed Treasury Regulations thereunder. In general, a cafeteria plan that fails to operate in accordance with these requirements is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.

Prop. Reg. § 1.125-6(b)(2) provides that all claims for reimbursement must be substantiated. Prop. Reg. § 1.125-6(b)(2) provides that “[s]ubstantiating only a percentage of claims, or substantiating only claims above a certain dollar amount, fails to comply with the substantiation requirements of § 1.125-1 and this section.” See *also* Treas. Reg. § 1.105-2; Rev. Rul. 2003-43, 2003-21 IRB 935 (holding that sampling techniques do not satisfy the substantiation requirements). Prop. Reg. § 1.125-6(b)(3) provides that all claims for reimbursement must be substantiated by an independent third party and may not be self-substantiated.

Specifically, Prop. Reg. § 1.125-6(b)(3) provides that “[a]ll expenses must be substantiated by information from a third party that is independent of the employee and

the employee's spouse and dependents." All amounts paid under a health FSA that permits self-substantiation are included in gross income, including amounts that are reimbursed for medical expenses, whether or not substantiated. See Notice 2006-69, 2006-31 IRB 107, 109 (holding that self-certification does not satisfy the substantiation requirements).

Flexible spending arrangements for dependent care assistance must follow the substantiation rules applicable to health FSAs. Prop. Reg. § 1.125-6(g) provides additional rules for reimbursing dependent care assistance through a debit card. If an employee submits the dependent care expenses to the employer through a debit card, these expenses must be substantiated by providing a statement from the dependent care provider substantiating the dates and amounts for the dependent care services provided.

Prop. Reg. § 1.125-6(a)(4) provides that reimbursements of dependent care expenses may not be reimbursed before the expenses are incurred. Dependent care expenses are incurred when the care is provided and not when the employee is formally billed or charged for (or pays for) the dependent care.

Prop. Reg. § 1.125-6(b)(4) provides that reimbursing expenses before the expense has been incurred or before the expense is substantiated fails to satisfy the substantiation requirements of Treas. Reg. § 1.105-2, Prop. Reg. § 1.125-1 and Prop. Reg. § 1.125-6(b)(4).

DISCUSSION

In *Situation 1*, the substantiation of all claims complies with the requirements of section 105(b) and the proposed regulations under section 125 including the substantiation requirements under Prop. Reg. § 1.125-6(b). Nothing in the way the plan substantiates the claims will prevent the employer from excluding the amounts reimbursed from the employee's income and wages for FICA and FUTA tax purposes.

In *Situation 2*, the self-certification of claims that are not otherwise substantiated does not ensure that every claim be substantiated. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated, the plan does not satisfy the cafeteria plan substantiation requirements under section 125. See Prop. Reg. § 1.125-6(b) requiring substantiation for all claims, regardless of the amount, and Prop. Reg. § 1.125-6(b)(3) prohibiting self-substantiation of medical expenses. See *also* Notice 2006-69, 2006-31, IRB 107 providing that all amounts paid under a health FSA plan that allows self-substantiation of medical claims are included in gross income.

In *Situation 3*, the sampling technique does not ensure that every claim is substantiated. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated, the plan does not satisfy the cafeteria plan

substantiation requirements under section 125. See Prop. Reg. § 1.125–6(b) requiring substantiation for all claims, regardless of the amount and Rev. Rul. 2003–43 holding that sampling techniques do not satisfy the substantiation requirements.

In *Situation 4*, the plan does not require employees to substantiate charges to the debit card for claims below a dollar threshold. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated (including expenses that are auto-substantiated), the plan does not satisfy the cafeteria plan requirements for substantiation under section 125. See Prop. Reg. § 1.125–6(b) requiring substantiation for all claims, regardless of the amount.

In *Situation 5*, the plan does not require employees to substantiate charges to the debit card from certain dentists, doctors, hospitals, or other health care providers. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated (including expenses that are auto-substantiated), the plan does not satisfy the cafeteria plan requirements for substantiation under section 125. See Prop. Reg. § 1.125–6(b) requiring substantiation for all claims, regardless of the amount.

In *Situation 2*, *Situation 3*, *Situation 4*, and *Situation 5*, the plan fails to satisfy the requirement to substantiate medical expenses. Reimbursements for unsubstantiated medical expenses under the cafeteria plan are not excludable from gross income under section 105(b). Therefore, in *Situation 2*, *Situation 3*, *Situation 4*, and *Situation 5* all reimbursements made during the year, including amounts paid to reimburse substantiated medical expenses, are included in the gross income of the employees.

In *Situation 6*, all claims for payment or reimbursement of the employee's dependent care assistance program are not substantiated because they are claimed in advance without additional verification. Because the plan does not limit reimbursements or payments of claims to dependent care assistance expenses that have been incurred or substantiated, the plan does not satisfy the requirements of section 129 and does not satisfy the cafeteria plan requirements of section 125. Therefore, the reimbursements for dependent care assistance expenses are not excludable from gross income under section 129, and all payments made during the year under the dependent care assistance program are included in the gross income and wages of the employees for FICA and FUTA tax purposes.

Further, in *Situation 2*, *Situation 3*, *Situation 4*, *Situation 5*, and *Situation 6*, failure to comply with the substantiation requirements of Prop. Reg. § 1.125–6(b) results in the failure to operate in accordance with its written plan or the failure to operate in accordance with section 125 and Prop. Reg. § 1.125–1(c)(7)(ii)(G).

Please call (202) 317-6700 if you have any further questions.