PAYFLEX®

Approach for Handling Unsubstantiated Expenses and Overpayments
Revised 2023

Purpose: This document explains why PayFlex suspends debit cards in certain instances, and also why income reporting via Form W-2 is required when debit card transactions have not been substantiated, when substantiation shows the transaction was for an ineligible expense or when other overpayments may have occurred on the account. It further outlines the steps PayFlex takes in servicing the plan and the steps necessary of employers when all other corrective actions fail.

1. Why do debit card transactions require substantiation?
Internal Revenue Service (IRS) regulations drive what type of debit card transactions may be automatically approved. Transactions that are not automatically approved require after-the-fact substantiation. After-the fact-substantiation is necessary since we don't know what the expense was for, the date of service and the financial liability after applicable insurance. We only know the merchant who was paid, the date and amount of the card swipe. We could not approve a claim filed with only a credit card receipt as documentation. As a result, we may need additional information for a card transaction.

2. Which transactions may be automatically approved?
The only transactions that may be automatically approved and do not require additional substantiation are:

a. Co-pay matches. Since co-pays are specific dollar amounts and not a percentage of the expense such as co-insurance amounts, co-pays can be approved.
b. Merchants using Inventory Information Approval System (IIAS) for prescription medications and eligible over the counter items.
c. Recurring but previously approved transactions. Since these were properly substantiated once, they can be automatically approved subsequently.
d. Carrier claim file matching. This is third-party notification that the expense is eligible and includes date of service and amount remaining after insurance pays.

<u>All other transactions, similar to claim requests, require substantiation.</u>

3. Why is a card suspended?
IRS regulations outline the corrective steps that must be followed if a debit card transaction is not substantiated and/or was not for an eligible expense. The corrective steps, which include card suspension, are:

a. Card suspension
b. Offset transaction with previously non-reimbursed eligible expenses
c. Request repayment
d. Withhold from paycheck as an after-tax deduction in accordance with state laws
e. Handle as business would any other uncollected debt for an employee which could include income reporting

4. Which steps does PayFlex take as the third-party administrator?
PayFlex has designed its system to accommodate the first 3 corrective steps listed in 3. a.-c. above as follows:

a. Send Request for Documentation letter(s) requesting the substantiation to the impacted member.
   1) The letter explains the member's options if they cannot locate the documentation. The three (3) options for keeping the card from being suspended are:
      i. Submit the required documentation for the card transaction to PayFlex;
      ii. Submit a different eligible and previously unreimbursed expense to offset to PayFlex; or
      iii. Send repayment to PayFlex for the unsubstantiated amount. The account is credited with this amount and is available for future eligible expenses.
   2) Letters are sent quarterly.

3) If no response to the first letter, a second letter is sent.
4) Notification is also sent when the card is suspended.

b. If no response is received to either the first or second letter, the card is suspended. As stated above, a suspension letter is sent to the member.
    1) Upon suspension, the account is placed in an overpay status for the amount of the unsubstantiated transaction(s). This means the account paid the provider for an expense which has since been deemed unsubstantiated or ineligible.
    2) Card remains suspended until overpay status is resolved.
c. Once the card is suspended, the member may still file a claim to request reimbursement. PayFlex automatically applies these eligible claim amounts against the overpaid amount.
    1) When the overpay status is cleared, the card is unsuspended.

5. What are the final 2 corrective steps?
If the card remains suspended and transactions remain unsubstantiated after PayFlex administers its corrective steps, the final two (2) corrective steps listed in 3. d. and e. above are administered by the employer or plan sponsor:

a. Withhold from paycheck as an after-tax deduction in accordance with state laws.
b. Handle as business would any other uncollected debt which could include income reporting.

6. How does PayFlex help the employer with the final 2 corrective steps?
PayFlex cannot act as the employer's accountant or legal counsel. We designed our system to find a solution that gives the member every chance to correct the issue and retain the tax-free benefit. We also try to not pass unnecessary administrative burdens on to the employer while helping the employer comply with the regulations and retain the tax deductible status of the plan. As a result, PayFlex has an Overpaid Employees report available on the employer portal that provides the amount of overpayment by member along with effective date of account status. It is available as an on-demand or scheduled report. This allows the employer to monitor card status throughout the year. This report also lists the cash overpayments which may occur when notice of termination is received after a claim had been processed or an expense is determined to be ineligible upon receipt of additional information.

7. Is there any IRS guidance on how to report the unsubstantiated amount?
Yes. IRS Memo 201413006, released March 28, 2014, confirms what had previously been informal guidance. At the time the unsubstantiated transaction(s) become business debt, the payment should be reported as income (wages) on Form W-2 and subject to withholding and employment taxes. The IRS also confirmed the debt may be reported in the year it is forgiven. It does not need to be reported in the year the expense was incurred. Being able to report on the W-2 issued after the plan year closes can be key to reducing administrative burdens.

8. What are the advantages of waiting until the plan year closes before considering the overpayment as a taxable event?
*The advantages to the **employee** are:*

a. By waiting until at least the end of the run-out before characterizing the overpayment as a business debt, the employee is receiving extra time to provide substantiation, offset claims or provide repayment.
b. The employee is able to, in most cases, retain the tax-free benefit for at least one more year.

*The advantages to the **employer** are:*

a. The employer will have time to gather information needed and use other debt collection steps before reporting as income.
b. This should help reduce reasons for issuing amended W-2s.

Examples:

a. Plan Year is January 1, 2020 to December 31, 2020. After run-out ends on March 31, 2021:
    i. Member has unsubstantiated expense dated June 15, 2020. It is reportable in 2021.
b. Plan Year is June 1, 2020 to May 31, 2021. After run-out ends on August 31, 2021:
    i. Member A has unsubstantiated expense dated October 1, 2020. It is reportable in 2021.

9. Why is the W-2 to be used instead of a 1099?

The IRS has confirmed in its Memo 201413006 that Form W-2 is the method for reporting a member's unsubstantiated transactions and overpayments. The reasons are:

a. Form W-2 is the form used to report compensation and taxable income for employees. Form 1099 is used for independent contractors.
b. Members could not have the benefit if not employees of a sponsoring employer.
c. The reimbursements are the result of an employer benefit provided through either salary reductions and/or employer contributions. As such, they are not subject to income withholding and employment taxes if regulations are followed. If regulations are not followed, reimbursements are taxable since there is no proof they were for eligible medical expenses.
d. IRS Memo 201413006 does not provide guidance on how to handle terminated employees with overpayments/unsubstantiated expenses, if the employee doesn't have a final W2 that can be used to include the overage as taxable income. You will want to review with your legal counsel or payroll advisor

Regulatory Citations:

IRS Memo 201413006
IRS Memo 202317020
Prop. Treas. Reg. § 1.125-6(c) through (f)
Rev. Rul. 2003-43
IRS Notice 2006-69
Priv. Ltr. Rul. 8315021
Treas. Reg. § 1.6041-2(a)(1)
Treas. Reg. § 31.3401(a)-1

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