
FSA Debit Cards: A Key Strategy for Employers

by Colleen M. Nelson

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For employers seeking strategies to manage costs, improve benefits and empower their employees, the combination of FSAs, HRAs, transportation plans and debit cards may well be an ideal strategy toward reaching their goals.

When first introduced in the late 1990s, the use of stored value or debit cards for flexible spending account (FSA) benefit plans was projected to skyrocket. They were touted as being convenient, cost-effective and a way to add a low-cost, yet attractive perk to employee benefit plans. While all these benefits were and are true, even the best laid plans of human resources executives and benefits consultants don't always come to fruition. Uncertainty over Internal Revenue Service (IRS) rulings and pending legislation as well as employees' fears over losing unused funds greatly inhibited growth.

But that should soon change. A myriad of factors are coalescing and may soon make debit cards for FSAs as widely used as credit cards at the local gas station.

While promising, plan sponsors need to thoroughly understand the role of debit cards and the specific implications of new technologies, pending legislation and regulatory guidance. The key for employers that want to maximize FSA par-

ticipation as a tool to empower employees and manage pretax expenses is to ensure they fully understand current and anticipated government regulations, examine current technology and commit to fully educating employees.

The factors impacting the growth of FSA debit cards that plan sponsors need to thoroughly analyze and understand, include:

- The growth of consumer-driven health care (CDH)
- Advances in technology
- New legislation from Congress on the "use-it-or-lose-it" rule
- Changes to transportation plan benefits.

A History of FSA Debit Cards

Introduced in the late 1970s, flexible spending accounts (FSAs) are a feature of Section 125 cafeteria plans that provide for health care and dependent care reimbursement. FSAs allow employees to set aside pretax portions of their compensation to pay for health care and dependent care expenses that are not covered under their basic employee benefit program. Employers benefit as FSAs provide an easy-to-administer and attractive benefit addition. Moreover, by lowering employee salaries through FSA deductions, the employer FICA (Federal Insurance Contribution Act) contributions are reduced by about 7.5% per \$1 contributed.¹ In most states, employers also reduce their workers' compensation payroll base for every dollar that employees contribute through the Section 125 plans.

While promising and providing tax advantages to both employers and employees,

FSAs never quite grew as anticipated. Employers and employees viewed FSA rules as severely limiting. Employers that instituted the plans had to collect employee contributions from payroll and track and adjudicate claims—a cumbersome process that required heavy paperwork in the human resources department or outsourcing to third-party administrators (TPAs).

FSA debit cards were introduced in the late 1990s. The cards, which are based on the same concept and technology as bank debit cards, electronically store data concerning an employee's FSA contribution and include filters and edits that incorporate the specifics of the benefit design such as copays and deductibles. When the card is swiped at a participating approved vendor, such as a hospital, pharmacy or medical office, the appropriate amount is deducted.

At their low point, only about 15% of eligible employees actually used an FSA. An estimated 4.5 to 6.8 million workers currently are enrolled in an FSA. However, 22.5 million have access to such accounts.² With recent changes, participation is expected to grow significantly over the next five years.

The Advent of CDH

One of the most significant factors influencing FSA debit cards is the growth of consumer-driven health care (CDH) plans, particularly health reimbursement accounts (HRAs). To date, most of the major health plans have introduced some type of CDH plan and new vendors and programs are being introduced at near dizzying rates. These plans promise to

empower consumers by giving them more flexibility and control over their health care benefit dollars. Many analysts believe that FSA and HRA debit cards are a first step in giving employees the control they need over health care expenses. With the cards, employees will be encouraged to better understand their benefits, make more informed health care decisions and track their health care spending. Some plans even enable participants to check their debit card balances and coverages online. What's more, debit cards are more convenient for plan members. They simply present the card and the adjudication process begins. No more paperwork or cumbersome forms. However, it is important to note that depending on the service, receipts or other substantiation may be required.

While the majority of consumer media has focused on the value CDH can bring to employees, when structured properly, it will also offer numerous benefits to plan sponsors, particularly when paired with a debit card. For example, using an HRA with a debit card not only frees employers from much of the administrative burdens of processing and administering claims, but it also gives them the ability to specifically forecast what they are spending on health care each year.

Advances in Technology

While the societal shift toward CDH is important to plan sponsors, so too are advances in technology. For example, debit cards now provide an electronic means of accurately verifying qualified medical expenses at the point of service. That means a primary concern for employers—employees using the card at noncovered retail outlets—has now been reduced. Claims adjudication is also much easier with the debit card because typically a third-party administrator (TPA) will manage the FSA balances and provide online or toll-free telephone access to employees. Through sophisticated software programs, experienced TPAs can provide daily reports on transactions that may require further substantiation or investigation. For example, a claim for laser eye surgery would not be autoadjudicated. Through the automated system, the TPA would be notified of the transaction and would contact the employee for substantiation.

IRS Rulings

Over the past several years, uncertainties due to ambiguous guidance from IRS caused many employers to shy away from debit cards. The primary concern was that employees might use the benefit for noncovered expenses. Additionally, there was uncertainty as to what type of documentation was required to substantiate claims. For employers, one of the main reasons to now consider FSA debit cards is the latest guidance from IRS on electronic transfers, namely, Revenue Ruling 2003-43. The ruling generally relaxes the IRS substantiation requirements for FSAs and HRAs and facilitates the use of electronic payment cards provided certain requirements are satisfied.³

In essence, the ruling clarifies the existing IRS substantiation requirements. For example, employees must certify that expenses are eligible and not reimbursed from any other source, and the medical provider must substantiate that the expense has been incurred. However, the ruling clarifies that the necessary certification, substantiation and adjudication can occur electronically, if the participant verifies and provides the following documentation:

- Certifies upon enrollment (and each plan year thereafter) that the card will only be used for eligible medical expenses
- Attests that any expense paid with the card has not been reimbursed from any other source and will not be submitted for reimbursement under any other plan (this certification may be included on the back of the card and reaffirmed by card swipe) and retain sufficient documentation for any expenses paid with the card.

Another key point clarified by the IRS ruling is that adjudication is required for

every health FSA or HRA claim. Again, the good news is that the adjudication may occur electronically making it easier for employees and less time-consuming and costly in terms of administration for the employer. Analysts believe that the ability to adjudicate claims electronically is a key benefit and will likely encourage many employers to adopt debit cards.

There are, however, some guidelines employers must keep in mind. Generally, card usage must be limited exclusively to medical providers (i.e., by merchant codes). In addition, substantiation must occur via one or more of the following:

- Correlation of the amount of the expense to a specified copayment under the plan
- Correlation of the amount of the expense to a recurring amount for a previously approved charge (e.g., a prescription refill) at the same provider
- Real-time substantiation via tie-in with an independent third-party adjudicator (e.g., a pharmacy benefits manager). After-the-fact auditing or sampling alone is not recognized as an adequate substantiation method.

The ruling also provides guidelines that help to protect employers in the event a "bad" or inappropriate payment is discovered. Specifically, employees are required to pay back the amount to the plan. If not successful, the amount can be withheld from wages (to the extent consistent with applicable law). In addition, the employer must take additional steps to ensure no further violations occur (e.g., denial of access of card until amounts are recouped).

Transportation Plans

While the new ruling represents a significant advancement for debit cards,

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other guidance employers have been watching for from IRS relates to Section 132 transportation plans, also known as parking reimbursement or mass transit accounts. Parking reimbursement allows participants to pay for daily or monthly parking expenses incurred for parking at or near the workplace. A participant can elect to have up to \$190 per month deducted from a paycheck to cover the cost of parking on a tax-free basis. Likewise a mass transit reimbursement account allows a participant to pay for mass transit expenses related to commuting to work. Up to \$100 per month can be deducted from the participant's paycheck tax free for qualified mass transit expenses. Covering transportation expenses has become an important perk for employers that want to reward employees who incur commuting (mass transit, van pool) and parking expenses and those that want to provide an added incentive to skilled employees who may live significant distances from the main office. In the past, the procedure for reimbursing for transportation expenses was relatively straightforward. The employee incurred an eligible expense and he or she simply submitted a claim for reimbursement.

However, as of January 1, 2004, employers will no longer be able to provide cash reimbursement for mass transit expenses. Specifically, in locations where transit passes are readily available, passes must be purchased and distributed by the employer or TPA to the participants in the plan. Employers are scrambling to find solutions and many are concerned that purchasing vouchers from a range of transportation and parking providers will be the only option. However, debit cards provide the perfect solution. IRS has said that it will indeed accept the use of debit cards for transportation-related expenses. With the use of a debit card, plan expenses are deducted from salary reductions at the point of sale and thereby eliminate the need for completing and submitting time-consuming claim reimbursement forms. Moreover, the debit card offers plan participants the convenience, flexibility and freedom of accessing their pretax deductions with the ease of a card swipe when purchasing mass transit cards, parking passes and van pool vouchers. Employee accounts for which the employer typically received regular activity reports are updated automatically with

every card swipe. For employers, the debit card provides a seamless benefit by accessing multistate locations and eliminates the headache of dealing with multiple regional transit authorities.

Pending Legislation

While technology and new IRS rulings matter to employers, employees have been closely watching legislation concerning the "use-it-or-lose-it" rule. Sponsored by Representative Ed Royce (R-Calif.) and known as HR 176, the bill would amend the current law to allow amounts elected for reimbursement of medical expenses under an FSA that are unused during a plan year to be carried over for the next year. The bill provides for the rollover of a maximum limit of \$2,000 per plan year.⁴ The bill also allows employees to transfer unused funds to a subsequent employer to be used in a similar arrangement. Likewise employees could cash out the unused funds on a taxable basis as regular earned income. In contrast to the current forfeiture rule that discourages employee participation, such a change would likely bolster participation in FSAs significantly.

There are several similar bills also pending. Many industry analysts believe that with the number of items pending and current interest from a broad base of bipartisan sponsors in abolishing "lose it or use it," that some legislation will likely pass in 2003. As of this writing, passage of HR 176 appears most likely.

Why Rethink FSA Debit Cards Now?

The coalescence of technology, legislation and new IRS rulings makes now the ideal time for plan sponsors to revisit the addition of debit cards as a strategy to provide both a convenient benefit to employees and to increase FSA plan participation. On average, employers with debit cards experience a 25% increase in FSA participation and a corresponding 25-30% increase in the dollar amount of the contributions. This translates into an increase of 60% or more in money going into the FSA, which means employers can realize a 60% savings on FICA, FUTA (Federal Unemployment Tax Act) and even state and local taxes.

Making It Work

But securing optimal benefits from FSA and debit cards goes well beyond simply offering the card to employees. Employers need to ensure they select the right debit card program for their organization and ensure they take the time to fully educate employees on both FSAs and the guidelines for using the debit card.

Here are some steps plan sponsors should take to ensure an FSA debit card program provides real value.

- *Determine the advantages that may be realized with an FSA.* Consider the savings per dollar for FICA, FUTA and RRTA (Railroad Retirement Tax Act) taxes, if applicable, as well as state and local taxes.
- *Analyze the current benefit structure.* Have copays and deductibles increased? Have there been other significant changes to the benefit over the past year? If so, the addition of an FSA debit card program may be viewed by employees as an important step to help make the benefit more attractive and user-friendly.
- *Educate employees.* There are some significant misconceptions regarding FSAs. In particular, when first introduced, employees had to pay for the expense out of pocket, submit a claim and then wait for reimbursement. Because the monies were already deducted from their paycheck, employees perceived they were paying twice, often with long delays until payment. With FSA debit cards, employees no longer need to worry about paying twice because the participant has already had the funds deducted and the corresponding amount is credited to the debit card. The key for a successful debit card program is a strong education program that highlights the value of the debit card and shows precisely how it works.
- *Institute safeguards that will protect the employer.* A primary concern of employers has been employees who use the card for noncovered items. Most debit cards only validate charges from an authorized health care provider such as a medical facility, pharmacy or hospital. While an important step, that does not prevent employees from going to a pharmacy—or

other approved retail outlet accepted by the card—and charging for items that are not part of the benefit. Therefore employers, working with their benefit vendor, must develop procedures to ensure that ineligible claims are recovered and that there are substantial penalties for misuse of the card. The new IRS ruling makes this type of recovery much more straightforward. Some debit card vendors and benefits administrators take responsibility for securing reimbursement for improperly charged items so that the employer is not at risk for “bad” or inappropriate charges.

- *Ensure that using the debit card is as simple and convenient to use as possible.* Some TPAs recommend that because copays—usually in the amounts of \$10 to \$20—are easy to identify and track, they may only require correlation rather than submission of a receipt for substantiation. However, other qualified expenses, as outlined

in the new IRS ruling, should be substantiated with receipts. This is a simple step for employees because most are already in the habit of saving health care receipts.

The Path to Choose

For many years, flexible benefits have been viewed as anything but that. Cumbersome paperwork, fear over losing benefit dollars and a myriad of other factors made FSAs less than appealing. But the tide is changing. Legislation, regulation and the quest by both employers and employees to find ways to manage health care costs are clearly paving the way for both flexible benefits and debit cards. For employers seeking strategies to manage costs, improve benefits and empower their employees, the combination of FSAs, HRAs, transportation plans and debit cards may well be an ideal strategy toward reaching their goals. What’s more, this approach clearly has the attributes

and features to become the preferred path toward true flexibility in the benefits marketplace. ◆

Endnotes

1. John G. Simmons, “Flexible Benefits for Small Employers,” *Journal of Accountancy*, March 2001.
2. Employers Council on Flexible Compensation. <http://www.benefits.net/pubs/fbb.htm>.
3. IRS Revenue Ruling 2003-43. <http://www.irs.gov/pub/irs-drop/rr-03-43.pdf>.
4. Sue Burzawa, “Debit Cards Add Convenience for FSA Participants, Reap Participation Gains for Employers,” *Employee Benefit Plan Review*, June 2002, pp. 34, 36, 38, 40.

MORE INFO

For more information on this topic:

- *Flexible Benefits: A How-To Guide*, by Richard E. Johnson. To order, call (888) 334-3327, option 4, or visit www.ifebp.org/bookstore.

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