

Part III – Administrative, Procedural, and Miscellaneous

Section 105.-Amounts Received Under Accident and Health Plans

Notice 2007-2

PURPOSE

This notice provides transition relief with respect to the use of debit cards for medical expense reimbursements at certain merchants with non-health care related merchant category codes. It also addresses the use of debit cards for medical expense reimbursements at stores with the Drug Stores and Pharmacies merchant category code.

BACKGROUND

Rev. Rul. 2003-43, 2003-1 C.B. 935, sets forth rules for determining whether employer-provided medical expense reimbursements made through debit cards and other electronic media (debit cards) are excludable from gross income under §105(b) of the Internal Revenue Code. Situation 1 of the ruling describes an employer who sponsors both a health flexible spending arrangement (health FSA) and a health reimbursement arrangement (HRA). In conjunction with the health FSA and HRA, the employer permits electronic reimbursement of medical expenses through the use of debit cards. Under the arrangement, the cardholder's use of the card is limited to merchants and service providers with specific merchant category codes related to health care. The ruling states that, "the card's use is limited to physicians, pharmacies, dentists, vision care offices, hospitals, and other medical care providers." Thus, the use of the card at other than these merchants or service providers would be rejected.

Situation 1 of Rev. Rul. 2003-43 also sets forth rules for substantiation of medical expenses and provides that debit card charges other than matched copayments, recurring

expenses and real-time substantiation are treated as conditional pending confirmation of the charges through additional third-party information. If the debit card charges are subsequently identified as not qualifying for medical reimbursement, the employer must follow certain correction procedures with respect to the improper payments. The after-the-fact substantiation and correction procedures described in Situation 1 of Rev. Rul. 2003-43 are sometimes referred to as “pay and chase.” The ruling holds that employer-provided medical expense reimbursements made through the cards, as described in Situation 1, are excludable from gross income under § 105(b).

Notice 2006-69, 2006-31 I.R.B. 107, describes an inventory information approval system that may be used by merchants with non-health care related merchant category codes for substantiating employees’ claimed medical expenses. It has been determined that transition relief is warranted for a limited period, in order for these non-health care merchants to implement the inventory information approval system.

TRANSITION RELIEF

All supermarkets, grocery stores, discount stores, and wholesale clubs that do not have a merchant category code related to health care will nevertheless be deemed to be an “other medical care provider” within the meaning of Situation 1 of Rev. Rul. 2003-43 with respect to debit card transactions occurring on or before December 31, 2007. In addition, mail order vendors and web-based vendors that sell prescription drugs will also be deemed to be an “other medical care provider” with respect to debit card transactions occurring on or before December 31, 2007. As required in Rev. Rul. 2003-43, employers must substantiate all debit card charges incurred during the relief period and follow the correction procedures in Rev. Rul. 2003-43 with respect to any unsubstantiated payment.

After December 31, 2007, health FSA or HRA debit cards may not be used at any store, vendor or merchant that does not have health care related merchant category codes unless the store, vendor or merchant has implemented an inventory information approval system as described in Notice 2006-69.

STORES WITH DRUG STORES AND PHARMACIES MERCHANT CATEGORY CODE

Under Rev. Rul. 2003-43, health FSA and HRA debit cards may be used at stores with the merchant category code for Drug Stores and Pharmacies. However, many stores with this code also sell a significant number of items which do not qualify as medical expenses under § 213(d). In order to curtail the ability to purchase non-medical items with such debit cards, as well as to provide a level playing field, the IRS and Treasury have determined that it is appropriate to require similar substantiation rules for all stores that sell a significant number of items which do not qualify as medical expenses under § 213(d).

Accordingly, after December 31, 2008, health FSA and HRA debit cards may not be used at stores with the Drug Stores and Pharmacies merchant category code unless (1) the store participates in the inventory information approval system as described in Notice 2006-69, or (2) on a store location by store location basis, 90 percent of the store's gross receipts during the prior taxable year consisted of items which qualify as expenses for medical care under § 213(d) (including nonprescription medications as described in Rev. Rul. 2003-102, 2003-2 C.B. 559).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2003-43, 2003-1 C.B. 935 is modified.

DRAFTING INFORMATION

The principal author of this notice is Stephanie L. Caden of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Caden at (202) 622-6080 (not a toll-free call).