

Update Bulletin

FSA and HRA Debit Card Legislation — Impact on POS for Grocery and Drug Retailers

February 2, 2007

No-Frills Summary

- Employees in companies with FSA/HRA plans can now access their benefit accounts via debit cards.
- The cards are legal only for eligible health expenses.
- But there is no current way to limit use of these debit cards only to stores that sell health-care items or enforce tender for those items only.
- Controlling these cards will mean big changes in POS, electronic payments and likely back office and hosting systems to itemize and control tenders.
- The industry specifications are not set, so the full system impact isn't known yet.
- Impacted grocers must install the changes in 2007.
- Start planning for upgrades.

Many companies provide a health care Flexible Spending Arrangement (FSA) or Health Reimbursement Arrangement (HRA). Employees can designate a specific amount of their paychecks to be contributed to these accounts — with the primary benefit that the contributions are pre-tax. All or part of an employee's health care expenses can therefore be paid with pre-tax dollars, lowering the financial impact of health-related expenses for many workers and their families.

In the past, the FSA/HRA funds were deposited with institutions who would then reimburse the employees for medical expenses upon receipt of application forms with attached receipts for expenses meeting requirements. Of course, this is a lot of paperwork and administration.

A new method has been selected that reduces administrative costs and simplifies reimbursement for the employee. This method provides debit cards for use with the employee's "account" which can be used to pay for approved medical expenses at point-of-purchase or point-of-service. Employers deposit the designated funds into the account, and the employee uses the debit card to access them when needed. There are no receipts to keep, no papers to file or delays waiting for reimbursement. This sounds perfectly sensible – but it gets very difficult for retailers very quickly.

TIME FOR Q&A:

Okay, I'll bite: what's so difficult? — The problem is separating valid medical expenses from purchases that do not qualify. A purchase consisting of a single prescription drug co-pay is easy — the expense qualifies, it is purchased at a pharmacy and there are no other items on the ticket.

But what if the shopper adds toothpaste and shampoo to the order? How does the clerk really know — and how does the POS system know — the valid amount for the debit card tender? — The short answer is "they don't."

And does leave the FSA/HRA system door open to shoppers using FSA debit cards to pay for anything in the store? — You bet.

And is the government concerned about this possible fraud? — See answer immediately above.

So how are these potential problems going to be solved? — The decision in Washington is that if a store wants to sell reimbursable items and accept an FSA/HRA card, all POS and almost certainly all back-office, hosting and wholesaler applications and databases must be upgraded to ensure that ineligible items cannot be purchased with that FSA/HRA debit card.

How about electronic payment systems? — Electronic payment systems and the POS interfaces will need substantial upgrades to handle the changes and prohibit inappropriate debit card use.

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But wait – why should this affect supermarkets? If a supermarket doesn't carry any eligible health care items, then so what? — Good thinking! Yes, if a store has no health-care items, then it is unlikely to be directly affected by the new regulations.

What will happen if a grocery-only store tries to take an FSA/HRA debit card? — An entire new payment type is being defined by the payment networks and institutions for these debit cards. If the card comes from a store where no health-care products are legally sold, the tender will be turned down.

How will the EPS or the network know? — You're sharp today. Part of the secret is a little item called the "merchant category code" (MCC). These codes are assigned to all retailers and are used by financial institutions to determine the merchant type (supermarket, fuel station, pharmacy) and among other things controls the interchange fee percentages the merchant is charged for transactions. For example, MCCs related to grocery stores trigger lower interchange fees than for consumer electronics centers or fuel retailers.

So that handles it and we're done then, right? — Not even close. More and more supermarkets have internal pharmacies — but most of these stores today use a grocery merchant category code, not a pharmacy code. The new rules will not allow any stores with a grocery MCC to accept FSA/HRA debit cards.

But that means that grocery stores with pharmacies would get cut out of the business! Who'd go to a pharmacy if you can't use your card there? — Exactly. So grocers have to upgrade their systems if they're going to offer bona-fide health-care products as well as non-reimbursable food items. Since both reimbursable and prohibited items will often appear in the same order, the POS system must be able to sort out one from the other and require a split tender, allowing exactly the right amount to be paid for via the debit card. The government calls it an "inventory information approval system."

How will this inventory information approval system work? — The specifications and requirements aren't yet available. The likely method will mean the upgraded POS will be able to categorize eligible and non-eligible items. When the shopper swipes an FSA/HRA card on the electronic payments system, the new EPS features will query the POS for the legal debit amount for the order. Then it will package up a special new FSA/HRA transaction type and send it up the network for approval.

How would this keep plain old groceries from being reimbursed with an FSA/HRA card? — Without an upgraded EPS, the store won't know how to file an FSA/HRA transaction correctly and the card would be turned down. If the EPS is upgraded but the POS doesn't have the required inventory information approval system to sort out the health-care reimbursable items, then the POS won't know how to interface with the EPS for an FSA/HRA transaction, and the EPS will not approve the card.

Sounds like WIC all over again. — Exactly right – except this time it includes electronic payments, interface requirements, infrastructure, and the additional complexity of handling the different MCCs differently.

So how many years until this cuts in? — Believe it or not, the regulations have *already* cut in. This is a done deal and grocers and grocery/pharmacy stores have to live by these rules.

No way! How come my customers aren't in jail? — Because right now there's a grace period (but everyone understands what a "grace period" is, so the government documents call it "Transition Relief" instead.



Quoting from government scripture, something-something-something Part III Section 105 Notice 2007-2:

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.

And in plain English? — It means that grocers who also sell reimbursable items may accept FSA/HRA cards for those items for the rest of 2007 while the rest of us scramble to rewrite and install new payments, POS, back office and hosting systems.

What about after 2007? — More scripture:

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.

What if it's a store that has a pharmacy MCC? Are they under the gun too? — Yes, but the safety is still on. They get an extra year:

... 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).

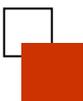
Hey Wait! So if a supermarket just changes their MCC to a drug store code they'll get an extra year before having to upgrade POS, right? — Very clever! But now their MCC wouldn't be "grocery" anymore, and they'd pay much higher interchange fees on *all* transactions.

In the Transition Relief period while the controls are put into place, what keeps everyone honest? Right now a shopper can use an FSA/HRA debit card anywhere for anything! — The Law has it all figured out, and employers get the short end of the stick. Reimbursements are currently "conditional pending third-party confirmation." These substantiation and correction procedure for improper payments is known as "pay-and-chase" — you get the picture.

How is StoreNext going to change all the products? What's the release schedule? — There are unfortunately no specifications yet on how these regulations are going to be met. Once these requirements and standards are set, we'll be in a position to schedule the changes. Meetings between the industry players are continuing this month and we hope they will result in specifications to which we can develop.

Will the industry make the deadlines? — The smart money says it's going to be tough. At this point, it looks like the technical changes required are liable to be major, meaning that some vendors will probably not finish the re-engineering and enhancements on time.

Will there be a charge to grocers for all this new software? — This is very likely.



This sounds like a lot of work ahead of us. Is there a silver lining somewhere?—These Federal directives — in combination with the PCI/CISP/Visa compliance mandates now hitting smaller and smaller grocers and being forced by payment processors and wholesalers — will drive many of your customers to finally upgrade their systems.

As the picture clears, StoreNext will keep you updated, including information sheets for you to assist your customers' understanding and planning

To Your Success,



Anthony van Seventer

