

Update Bulletin

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

December 12, 2007

No-Frills Summary

- Many employees in companies with FSA/HRA plans now access their benefits via debit cards.
- The cards are legal only for qualified 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 requires changes in POS, electronic payments and likely back office and hosting systems to itemize and control tenders.
- Starting 1-Jan-08, all grocers selling qualified products must implement an Inventory Information Approval System (IIAS) with upgraded software before they can process FSA/HRA cards.

Many companies provide a health care Flexible Spending Arrangement (FSA) or Health Reimbursement Account (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. Depending on the nature of the employer's plan, the employee may contribute funds or not, left-over amounts may be rolled over into future years, or refunded to the employee, accounts may be "loaded" up-front etc.

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.

The new debit card method 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. FSA cards are already in common use and growing fast, with about 80% of all reimbursements expected to be via FSA cards within two years.

Time for Q&A:

THE PROBLEM

Is FSA just the pharmacy issue? — It's not just the pharmacy. Items including everything from acne medicine to aspirin to hearing aid batteries are "qualified" expenses. Any grocer with a HABA aisle is affected.

What's so difficult about ringing up these items? — The problem is separating qualified medical expenses from purchases that do not qualify. A one-item order with a 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."

If the clerk can't tell if it's qualified, can't shoppers buy whatever they want and pay for it with the FSA card? — You bet. That's the problem the IRS is determined to fix.

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THE REQUIRED SOLUTION — IIAS

So how are these problems going to be solved? – The decision was to require stores to implement an Inventory Information Approval System – an “IIAS” – that can figure out (1) which items are health-care qualified and (2) automatically limit the FSA card tender to that qualified amount. All items in the store (the “Inventory”) must be tagged with itemizers describing health-care qualification (“Information”) which POS must sort on the fly into separate accounts and forwarding to the payments engine (“Approval”).

How does this inventory information approval system work? – The IIAS requires the upgraded POS to categorize qualified and non-qualified 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 FSA debit amount for the order. Then it will package up the special new FSA/HRA transaction types and send it up the network for approval.

Sounds like WIC all over again. – Exactly right - except this time it includes electronic payments, interface requirements, infrastructure, and the additional complexity of handling varying types of merchants in different ways.

Doesn't that mean a lot of changes? – It means 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 need substantial upgrades to handle the changes and prohibit inappropriate debit card use.

What happens if a POS system without an IIAS tries to use an FSA/HRA debit card? – An entire new set of payment types has been defined by the payment networks and institutions for these health-care cards. If the card comes from a store where no health-care products are legally sold via the card, the tender will be turned down.

How does the payment network know what kind of store it is? – Payment systems in a store are set up with Standard Industrial Classification codes (SIC codes - which are sometimes referred to in the IRS documentation as Merchant Category Codes or MCCs). 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, SIC codes related to grocery stores trigger lower interchange fees than for consumer electronics centers or fuel retailers.

How about the items themselves? Is it just that they're qualified or not, kind of like WIC? – The IIAS specification provides for five different types of qualifications that can be logged. These include FSA-eligible items, HRA-eligible items, pharmacy co-pays, vision care and dental care.

Does that mean that IIAS requires five new itemizers? – Fortunately, we all got a break on this one. Although the spec calls out five categories, the IRS has ruled that co-pays must be separate, but FSA, HRA, vision and dental eligible items can all be lumped into a single FSA category. So there are only two different itemizers that must be maintained.

How do grocers know which items are health-care qualified? – This information is available on several Web sites, including those operated by health-care insurance and services providers. Several wholesalers, including SuperValu, will provide PLU data to hosted member stores regarding health-care qualified UPCs.

Wasn't FMI or some other industry group going to set up a service for this too? – There was some talk about FMI contracting a third party to provide such an overall service, but so far as we know there has not been any firm plan. (In fact, despite its importance, there is almost no mention of FSA on FMI's Web site. Industry organizations have been remarkably quiet.)



GROCER ACTIONS AND ALTERNATIVES

So you're saying that all retailers have to change their technology right away? – Grocers must be compliant as of January 1, 2008. Drug stores and pharmacies have until January 1, 2009 to implement the IIAS and get compliant.

But wait - why should this affect supermarkets? If a supermarket doesn't have a pharmacy or carry any eligible health care items, then it won't matter, right? – Good thinking! Yes, if a store has no health-care qualified items, then it doesn't need to worry.

Do supermarkets carry many health-care items? – Big time. Much or most of the HABA aisle is health-care qualified and shoppers will want to use the FSA cards to pay for these purchases.

What if you have a grocery store with a pharmacy in it? – These systems have traditionally been set up using grocery-oriented SIC codes to ensure the lowest interchange rates.

So if a grocer doesn't have an IIAS by January 1, they can just change their code to a pharmacy-type code and everything's fine, right? – Not fine at all. They'll be paying higher interchange rates on everything in the store, plus it looks like it will be breaking federal law.

How about this: set up the pharmacy in the store with its own stand-beside PIN pad and tender just the pharmacy items there. This would be legal, plus keep the interchange rates down at the front end. Problem solved! – Good thinking, but there are big shopper service problems with this approach even if the IRS would approve.

What's wrong this time? – This means that the clerks have to memorize all the health care items and separate them manually from the groceries. Then they need to send the shopper to the pharmacy to tender those items. It also means the store can't sell grocery items in the pharmacy (wrong SIC) and keep the low rate, so that's more shopper service problems. Then the store needs to balance and reconcile against two different payment systems. And then there's the cost of the extra payments system.

If a grocer isn't ready for FSA on January 1, where can shoppers go where the situation is any better? – Pharmacies and big drug store retailers such as Rite Aid and CVS don't have to implement the IIAS until 2009, so shoppers can use their health-care debit cards there. Wal-Mart and Target are ready to process FSA IIAS transactions. Major chain grocers have also geared up and will be ready.

But health-care qualified items are just a small percentage of sales. It shouldn't affect the store very much, right? – The trouble is that shoppers come to the store and buy those health-care items along with all the other groceries. Once the shopper realizes that they can't use their card in the store, they'll take ALL their business to stores where they can.

Are shoppers using FSA cards in supermarkets today? – Absolutely. And they're accepted without any problem, regardless of what's in the order. Probably to the surprise of the shoppers, these cards can buy cigarettes, magazines, wine, toys, Christmas decorations and anything else on the shelves. Since there are no controls on the items until the IIAS is implemented, the payment transactions just go through like any other debit card.

Do grocers know how much FSA is being used today? – Rarely if ever. Since health-care cards are currently treated and processed like any other electronic transaction, clerks and merchants don't really know how many of their customers have been using FSA cards already. And almost certainly, those cards have been used to pay for the full ticket, not just the health-care qualified items. Shoppers seldom know exactly what's qualified and what isn't.

So on January 1? – It'll be a rude awakening when every health-care is rejected – regardless of how much money is in the FSA account. It will be rejected just because the store doesn't have the IIAS implemented.



So the risk for a grocer is? – Grocers who don't have a POS working under an IIAS scheme will have their shopper's cards turned down. Because of the embarrassment and ongoing inconvenience, some shoppers will take their business elsewhere.

RULES AND PRODUCT SCHEDULES

Are they serious? There's no way all stores could comply by January 1. When will it REALLY apply? – Believe it or not, the regulations have *already* cut in. FSA/IIAS 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 until January 1, 2008 there's been a grace period (but since everyone understands what a "grace period" is, the IRS 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 health care qualified items were able to accept FSA/HRA cards for those items for the rest of 2007 while the industry scrambled 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 SIC? 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).

Will StoreNext products be able to handle FSA transactions? – Yes. StoreNext POS and associated products will be able to handle FSA transactions.

What will be the cost for this capability? – the FSA option for ISS45 V7, V8 or ScanMaster V2 carries a list price of \$995. There are no license fees for the compatible versions

When will they be available, and what versions? – Status of the various products:

- ✓ ISS45 V7: version 7.1.2.1, first customer availability mid-December 2007
- ✓ ISS45 V8: version 8.1.2.1-070, first customer availability mid-December, 2007
- ✓ ScanMaster V1: no FSA features are planned
- ✓ ScanMaster V2: version 2.05.00, first customer availability mid-December, 2007
- ✓ U-Scan: currently-available StoreNext release version 44.



- ✓ WinEPS: version 823 SP2, general release planned mid-December 2007
- ✓ Connected Payments: FSA capabilities implemented as of mid-December 2007
- ✓ RBO: compatible version 4.6.0 planned/scheduled for first customer availability late January 2008, **planned with certifications over ISS45 8.1.3.0 and 7.1.2.1, and ScanMaster 2.5.1.**
- ✓ Retailix Store/HQ: updated version planned/scheduled for first customer availability late January 2008, **planned with certifications over ISS45 8.1.3.0 and 7.1.2.1, and ScanMaster 2.5.1.**
- ✓ PocketOffice: updated planned/scheduled for first customer availability late January 2008, **planned with certifications over ISS45 8.1.3.0 and 7.1.2.1, and ScanMaster 2.5.1.**
- ✓ Pricer ESL: no required changes

Are any new payment processes required? Like a different transaction type? – Yes, these FSA transactions will be a new hybrid and require different data to be provided to the payment networks. Although the tender medium is a “debit” card to an account containing funds, the transaction will be processed without a PIN as a “credit” transaction and the interchange fees will be at “signature debit” rates (similar to credit rates).

That means payment networks all need to upgrade to handle the new transactions. What about their schedules? Who’s ready? – At this writing, the Visa network is first out with readiness. MasterCard expects to be ready on January 1, 2008 but this doesn’t leave much time for certifications. Schedules for the American Express and Discover associations are supposed to follow at some point.

What about processors like First Data? Don’t they have to handle the new transactions too? – Absolutely. At this point, First Data, ACI and 5th/3rd are in good shape, and RBSLynk is expected to be ready as of the first of the year. Chase Paymentech is working to complete their solution, and LML, Mercury and Shazam will also be compliant but we don’t have a firm schedule at this point.

COMPLIANCE AND ARCHIVES

Is there a FSA-compliance audit system – as there is with PCI? – No. Without the IIAS, however, it’s technically impossible for a grocery store to process a health-care card transaction after January 1, 2008. The networks will reject all such transactions.

What if a grocer puts in payments and POS software with an IIAS but doesn’t bother managing the PLU file – they just set all items in the file as being FSA-qualified? – That’s possible. Very much illegal, but possible.

But if there’s no on-site certification, what’s going to keep them honest? – The IRS DOES plan to audit providers and retailers for compliance by examining past transactions to make sure that non-qualified items weren’t paid for with FSA funds.

But how can they do that? By the time the IRS asks for the data, those transaction logs will be long gone. Won’t they take too long? – Part of the IIAS requirement is that stores must archive all such health-care transactions for almost five years.

But that’s not really practical – isn’t it much too much data, and there aren’t any tools to isolate the FSA transactions and report them. – You’re right – especially with the need for off-site archival-quality storage. So StoreNext plans to implement a new connected storage, retrieval and reporting service for FSA transactions.

How would this service work? – StoreNext will automatically collect daily data using the Connected Services mechanism and provide the required long-term storage and the ability to quickly access and report the transactions demanded by the IRS to demonstrate compliance.



Hey! This can't work! They'll obviously need the card numbers, but PCI won't let you store card numbers for five years! – Apparently you can think faster than the guys making the rules. When StoreNext asked the same question, they had no idea how to handle the apparent conflict. However, since the IRS plans to audit merchants – not shoppers – they really don't need real or full card numbers. They just want to see that the UPCs that were tendered via FSA were health-care qualified. So StoreNext currently plans archive only the last four digits of the FSA or HRA card with the transaction.

What will the cost be for the connected FSA transaction service? Will it require other services or is it available separately? – StoreNext will announce details as soon as possible.

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 affecting smaller and smaller grocers and being forced by payment processors and wholesalers – will drive many small grocers to finally make the necessary upgrades to their systems.

Is StoreNext doing anything to make the transition easier and less expensive? – Yes. The Charter Offer for Connected Payments eliminates the license cost for the FSA option, and a special FSA Upgrade program (through Q1, 2008) enables grocers to upgrade their ScanMaster or ISS45 POS systems with no license upgrade charges – including many new features and free options – in conjunction with Connected Payments.

To Your Success,



Anthony van Sevelter

