



Legal Alert: IRS Issues Additional Guidance on Prohibition of Reimbursement for OTC Drugs and Medications

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On September 3, 2010, the IRS issued Notice 2010-59 addressing changes made by the Patient Protection and Affordable Care Act (Affordable Care Act), to the definition of "medical expenses" as it relates to over-the-counter drugs.

Section 105(b) of the Internal Revenue Code generally provides that the gross income of an employee does not include amounts paid as reimbursements of expenses incurred for medical care under an employer-provided accident or health plan. New §106(f) of the Code, as added by the Affordable Care Act, provides that, after December 31, 2010, expenses incurred for a medicine or a drug can be treated as medical expenses eligible for tax-free reimbursement *only* if such medicine or drug is a prescribed drug or is insulin. Therefore, after December 31, 2010, payments or reimbursements for medicines or drugs from an employer-provided accident and health plan, including a health FSA or an HRA, are restricted to prescribed drugs (including over-the-counter drugs that are actually prescribed) and insulin. This effective date applies regardless of the plan year and regardless of any applicable grace period under a health FSA. Expenses incurred for over-the-counter medicines or drugs that are purchased without a prescription *before* January 1, 2011 may still be reimbursed tax-free at any time, subject to the terms of the employer's plan.

The rules in §106(f) do not apply to items that are not medicines or drugs; this would include (i) equipment such as wheelchairs, crutches, etc., (ii) supplies such as bandages, syringes, etc., and (iii) diagnostic devices such as blood sugar test kits. Expenses for such items will continue to qualify as medical care expenses if they otherwise meet the definition of §213(d)(1), which includes "expenses for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."

With limited exceptions, debit cards issued under health FSAs and HRAs may not be used to purchase over-the-counter medicines or drugs after December 31, 2010. However, because of the need for systems changes, the Notice provides that the IRS will not challenge the use of health FSA and HRA debit cards for expenses incurred through January 15, 2011 if the use of the debit cards complies with current rules. However, on and after

January 16, 2011, over-the-counter medicine or drug purchases at all providers and merchants (whether they have an inventory information approval system (IIAS), or they meet the "90% test" under Notice 2007-2) must be substantiated before they may be reimbursed. For this purpose, substantiation is accomplished by submitting a copy of the prescription for the over-the-counter medicine or drug (or other documentation that a prescription has been issued), along with other required information from an independent third party. For example, a pharmacy receipt that identifies the name of the purchaser (or the name of the person for whom the prescription applies), the date and amount of the purchase and an Rx number will satisfy the substantiation requirements, as does a receipt without an Rx number but which is accompanied by a copy of the related prescription. Debit cards may continue to be used as they have been for medical expenses other than over-the-counter medicines or drugs.

Most cafeteria plans will probably need to be amended to conform to the new over-the-counter drug requirements. Normally, cafeteria plan amendments may be effective only prospectively. However, the Notice explicitly provides that an amendment to conform a cafeteria plan to the requirements of the Notice may be adopted by June 30, 2011 and may be made effective retroactively to apply to expenses incurred after December 31, 2010 (or after January 15, 2011 for health FSA and HRA debit card purchases).

The change in reimbursement procedures will also apply to health savings accounts (HSAs) and Archer medical savings accounts (MSAs). Expenses incurred after December 31, 2010 for over-the-counter drugs and medicines (other than those that are actually prescribed) will not constitute qualified medical expenses, and so may not be reimbursed tax-free; any such reimbursements will be both includible in income and subject to the additional tax on distributions that are not used for qualified medical expenses (which increases to 20%, effective January 1, 2011).

If you would like additional information about the changes discussed above, if you need assistance amending your plan, or if you wish to discuss how healthcare reform affects you, please contact the author of this Alert, [Jeffrey Ashendorf](mailto:jashendorf@fordharrison.com), jashendorf@fordharrison.com, any member of Ford & Harrison's [Employee Benefits](#) group, or the Ford & Harrison attorney with whom you usually work.

You may also visit the [health care reform](#) section of the Ford & Harrison website, <http://www.fordharrison.com/HealthcareReform.aspx>, for more helpful resources and tools on health care reform.