

IRS ISSUES NEW GUIDANCE REGARDING THE REIMBURSEMENT FROM EMPLOYER PLANS OF OVER-THE-COUNTER MEDICINE AND DRUGS

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On September 3, 2010, the Internal Revenue Service (“IRS”) issued two pieces of guidance – Notice 2010-59 and Revenue Ruling 2010-23 – to reflect certain statutory changes made to the Internal Revenue Code (“Code”) by the Patient Protection and Affordable Care Act (“Affordable Care Act”). These changes pertain to the ability of employer-sponsored health plans to continue to reimburse over-the-counter (“OTC”) medicine and drugs after December 31, 2010.

Under existing law in effect through the close of the 2010 tax year, *i.e.*, through December 31, 2010, employer-sponsored health plans, including flexible spending arrangements (“FSAs”), health reimbursement arrangements (“HRAs”), Health Savings Accounts (“HSAs”) and Archer Medical Savings Accounts (“Archer MSAs”), are generally permitted to pay for or otherwise reimburse on a tax-free basis all OTC medicine and drugs. Pursuant to section 9003 of the Affordable Care Act, employer plans generally will no longer be permitted to reimburse expenses incurred with respect to OTC medicines and drugs, unless such medicine and drugs are prescribed or are insulin.

Notice 2010-59 restates the general rule that, effective January 1, 2011, all employer-sponsored health plans (including FSAs, HRAs, HSAs, and Archer MSAs) may no longer reimburse expenses for an OTC medicine or drug, unless such drug is prescribed or is insulin.

Additionally, the Notice provides a host of important clarifications, including –

- ***The prohibition applies to all OTC medicine and drug expenses incurred on or after January 1, 2011, even if the funds were set aside in 2010.*** The Notice makes clear that even if funds are set aside by the employer prior to 2011 (this would seem to include amounts salary reduced or contributed by an employee or individual to a respective medical savings account, such as an FSA, HRA, HSA or Archer MSA, such amounts may not be used to pay for or reimburse OTC medicine and drug expenses incurred after December 31, 2010, unless prescribed or insulin.
- ***The January 1, 2011 effective date applies regardless of whether the applicable plan follows a calendar or fiscal plan year, and regardless of the use of any FSA grace period.*** Thus, it appears to be the case that OTC medicine and drug expenses incurred after December 31, 2010, even if incurred during the permissible 2 ½ month grace period for FSAs, may not be reimbursed from the FSA. The Notice does make clear, however, that such OTC expenses may be reimbursed on or after January 1, 2011, so long as the expenses subject to reimbursement were incurred prior to January 1, 2011.
- ***The new prohibition on the reimbursement of OTC expenses does not apply to items that are not medicines or drugs.*** Therefore, medical equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits, should



continue to be reimbursable. Notably, the Notice expressly states that “such items may qualify as medical care if they otherwise meet the definition of medical care in [section] 213(d)(1),” but warns that “expenses for items that are merely beneficial to the general health of an individual . . . are not expenses for medical care.”

- ***The term “prescription” is defined for purposes of the new rule by reference to underlying state law.*** The Notice states that for purposes of the new rule only, a “prescription” means “a written or electronic order for a medicine or drug that meets the legal requirements of a prescription in the state in which the medical expense is incurred and that is issued by an individual who is legally authorized to issue a prescription in that state.”

The Notice also provides a series of rules regarding the use of debit cards in connection with the reimbursement of OTC medicines and drugs. They are as follows:

- ***Limited relief for OTC medicine and drug expenses incurred through January 15, 2011.*** The Notice generally provides that health FSA and HRA debit cards may not be used to purchase OTC medicines or drugs. However, in acknowledgment of the fact that many “[c]urrent debit card systems are not capable of substantiating compliance with [the new rule],” and, “in order to facilitate the significant changes to existing systems necessary to reflect the statutory change,” 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.”
- ***Debit cards may continue to be used for medical expenses other than OTC medicines or drugs.*** The Notice clarifies that although debit cards may not reimburse OTC medicine and drug expenses incurred after January 15, 2011, debit cards are permitted to continue to reimburse other medical expenses. Thus, as noted above, debit cards may continue to be used for the purchase of medical equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits, so long as they otherwise qualify as medical care for purposes of Code section 213.
- ***Debit cards may continue to be used at a pharmacy that does not have a qualifying Inventory Information Approval System (“IIAS”) if 90 percent of the store’s gross receipts during the prior taxable year consists of items which qualify as expenses for medical care under Code section 213(d) and there is proper substantiation.*** Notice 2010-59 provides that until further guidance is issued, debit cards may be used at a pharmacy that satisfies the 90-percent test to purchase OTC medicines or drugs that have been prescribed, “provided that substantiation is properly submitted, in accordance with the terms of the plan, including the prescription (or a copy of the prescription or other documentation that a prescription has been issued) and other information from an independent third party that satisfies the requirements under Prop. Treas. Reg. § 1.125-6(b)(3)(i).” The Notice provides that for the purpose of determining whether a pharmacy

meets this 90-percent test, sales of OTC medicines and drugs at such a pharmacy may continue to be taken into account after December 31, 2010.

In addition to Notice 2010-59, the IRS also issued Revenue Ruling 2010-23. This Revenue Ruling obsoletes a prior revenue ruling, Revenue Ruling 2003-102, which had allowed for the reimbursement from employer health plans of expenses for OTC medicine and drugs.

If you have any questions, please contact Seth Perretta at Davis & Harman LLP at (202) 662-2298 or stperretta@davis-harman.com.

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