

Health Care Reform Update

Guidance on Reimbursement of OTC Drugs

As reported earlier, effective January 1, 2011 (regardless of an employer's plan year and regardless of a plan's grandfathered status), most over-the-counter ("OTC") medicines and drugs will not be eligible for reimbursement from health FSAs, HSAs, HRAs, or Archer MSAs.

This week, the IRS issued Notice 2010-59 providing additional information.

Expenses incurred for medicines or drugs may be paid or reimbursed by a health FSA or HRA, only if the medicine or drug:

- requires a prescription;
- is available without a prescription (an OTC medicine or drug) and the individual obtains a prescription; or
- is insulin.

If amounts are distributed from an HSA or Archer MSA for any medicine or drug which does not satisfy these requirements, the amounts will be distributions for nonqualified medical expenses, which are includable in gross income and generally subject to a 20% additional tax.

A "prescription" for these purposes 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 rules do not apply to items that are not medicines or drugs, including equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits. Such items may qualify as medical care if they otherwise meet the definition of medical care in § 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. However, expenses for items that are merely beneficial to the general health of an individual, such for a vacation, are not expenses for medical care.

DEBIT CARDS FOR HEALTH FSAS AND HRAS

Current debit card systems are not capable of substantiating compliance with new rules because the systems are incapable of recognizing and substantiating that the medicines or drugs were prescribed. Therefore, for expenses incurred on and after January 1, 2011, health FSA and HRA debit cards may not be used to purchase OTC medicines or drugs.

However, in order to facilitate the significant changes to existing systems necessary to reflect the statutory change, 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 prior requirements. On and after

January 16, 2011, OTC medicine or drug purchases at all providers and merchants (whether or not they have an inventory information approval system (IIAS)) must be substantiated before reimbursement may be made. Substantiation is accomplished by submitting the prescription (or a copy of the prescription or other documentation that a prescription has been issued) for the OTC medicine or drug, and other information from an independent third party that satisfies the substantiation requirements.¹ Thus, for example, a customer receipt issued by a pharmacy which 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 satisfies the substantiation requirements for OTC medicines or drugs as does a receipt without an Rx number accompanied by a copy of the related prescription. Debit cards may continue to be used for medical expenses other than OTC medicines or drugs.

Health FSA and HRA debit cards may be used at a pharmacy that does not have an 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 § 213(d). 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 substantiation requirements described in footnote 1. Solely for the purpose of determining whether a pharmacy meets this 90-percent test, sales of OTC medicines and drugs at the pharmacy may continue to be taken into account after December 31, 2010.

EFFECTIVE DATE

Expenses incurred for OTC medicines or drugs purchased without a prescription before January 1, 2011 may be reimbursed tax-free at any time, pursuant to the terms of the employer's plan (i.e., within the plan's run-out period and assuming the plan reimbursed the OTC drug to begin with).

For expenses incurred after December 31, 2010, payments or reimbursements for medicines or drugs from a health FSA or HRA are restricted to prescribed drugs, insulin, and OTC drugs that are prescribed. This effective date applies regardless of the plan year and regardless of any applicable grace period for a health FSA.

Tax-free distributions for qualified medical expenses from an HSA or Archer MSA for medicines or drugs purchased after December 31, 2010, are restricted to prescribed drugs, insulin, and OTC medicines or drugs that are prescribed.

TRANSITION RULE FOR CAFETERIA PLAN AMENDMENTS

Cafeteria plans may need to be amended to conform to the new OTC drug requirements. Even though amendments may not generally be made retroactively, an amendment to conform to these requirements

¹ All expenses must be substantiated by information from a third-party that is independent of the employee and the employee's spouse and dependents. The independent third-party must provide information describing the service or product, the date of the service or sale, and the amount. Self-substantiation or self-certification of an expense by an employee does not satisfy the substantiation requirements.

can be adopted by June 30, 2011 (effective retroactively for expenses incurred after December 31, 2010 (or after January 15, 2011 for health FSA and HRA debit card purchases)).

For the Notice, visit: <http://www.irs.gov/pub/irs-drop/n-10-59.pdf>.



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