

Legislative Brief

Health Care Reform: IRS Issues More Information for Employers on Over-the-Counter Drugs



EXECUTIVE SUMMARY

The Patient Protection and Affordable Care Act (PPACA) changed the requirements related to reimbursements for over-the-counter (OTC) drugs. These changes affect health FSAs, HRAs, HSAs and Archer MSAs, which will need a prescription to reimburse the costs of OTC drugs purchased after **December 31, 2010**.

On September 3, 2010, the IRS released **IRS Notice 2010-59**, which provides additional information on this requirement. The notice states:

- Reimbursement is restricted to prescribed drugs, insulin and OTC drugs that have a prescription;
- Health FSA and HRA debit cards cannot be used for OTC drugs, except as provided in the notice; and
- Required cafeteria plan amendments must be adopted by June 30, 2011 and can be retroactively effective.

This The Barnett Group Legislative Brief provides a summary of IRS Notice 2010-59. Please read below for additional information. See www.ecfc.org/files/legislative-news/n-10-59.pdf for a copy of the Notice.

IRS NOTICE 2010-59

General Rule

The Notice provides guidance on Section 9003 of PPACA, which revises the definition of "medical expenses" for employer-provided accident and health plans, including health flexible spending arrangements (health FSAs) and health reimbursement arrangements (HRAs). PPACA Section 9003 also revises the definition of "qualified medical expenses" for health savings accounts (HSAs) and Archer medical savings accounts (Archer MSAs). Section 9003 applies after **December 31, 2010**.

Under these rules, tax-free payment or reimbursement is only available after December 31, 2010, for expenses incurred for a medicine or drug if the medicine or drug is a prescribed drug (determined without regard to whether the drug is available without a prescription) or is insulin. This means that these expenses may be paid or reimbursed by an employer-provided plan (including a health FSA or HRA) or reimbursed tax-free by an HAS or Archer MSA if the medicine or drug:

- Requires a prescription;
- Is an OTC medicine or drug and the individual obtains a prescription; OR
- Is insulin.

Note that 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 plan.

What Is a Prescription?

For purposes of these rules, the Notice clarifies that 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.

Legislative Brief

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What About Other OTC Items?

The Notice makes clear that the requirement to get a prescription does not apply to OTC 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. These items can qualify for medical care if they otherwise meet the tax code's definition of medical care, 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, expense for items that are merely beneficial to the general health of an individual, such as an expenditure for a vacation, are not expenses for medical care.

Rules for Debit Cards

In most cases, health FSA and HRA debit cards will not be able to be used to purchase OTC medicines or drugs, effective January 1, 2011. This is because current debit card systems are not capable of recognizing and substantiating that the OTC medicine or drug were prescribed. However, see below for an exception for purchases at certain pharmacies. Also, debit cards may continue to be used for medical expenses other than OTC medicines or drugs.

In order to facilitate the significant changes to existing systems necessary to reflect the new rules, the IRS will not challenge the use of debit cards for expenses incurred through January 15, 2011, as long as the use follows existing rules. However, on and after January 16, 2011, OTC medicine or drug purchases at all providers and merchants must be substantiated **before** reimbursement may be made. This is the case even if the provider or merchant has an inventory information approval system (IIAS). 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 existing requirements.

The Notice gives examples of documentation that would satisfy the substantiation requirements for OTC medicines or drugs:

- 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.
- A similar receipt without an Rx number that is accompanied by a copy of the related prescription.

As noted above, there is an exception to the restrictions on debit card use for certain pharmacies. Prior IRS guidance (Notice 2007-2) provides that 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 Internal Revenue Code Section 213(d). The Notice states 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. 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 must be included. For the purpose of determining whether a pharmacy meets the 90-percent test, sales of OTC medicines and drugs at the pharmacy may continue to be taken into account after December 31, 2010.

Transition Rule for Cafeteria Plans

Cafeteria plans may need to be amended to follow the new requirements for OTC medicines and drugs. In general cafeteria plan amendments may be effective only prospectively. However, the Notice states that, notwithstanding the general rule against retroactive amendments, an amendment to conform to the cafeteria plan to the new OTC drug requirements that is adopted no later than June 30, 2011, may be made effective retroactively for expenses occurred after December 31, 2010 (or after January 15, 2011 for health FSA and HRA debit card purchases).

Legislative Brief

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Effective Dates

For expenses incurred after December 31, 2010, payments or reimbursements for medicines or drugs from an employer-provided accident and health plan, including a health FSA or HRA, are restricted to prescribed drugs, insulin, and OTC drugs that are prescribed.

This effective date applies regardless of whether the plan year for the employer's plan is a fiscal or calendar year or whether there is no plan year (or other coverage period in the case of an HRA), 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.

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