



Alfred B. Fowler
Attorney at Law

MEMORANDUM
2010-17

Health Care Reform: Over-the-Counter Drugs Gone – Almost

September 14, 2010

In 2003, the Department of Treasury/Internal Revenue Service issued a Revenue Ruling ([2003-102](#)) which has allowed group health plans including health FSAs, to provide benefits for non-prescription drugs and medicines purchased by plan participants. The Health Care Reform Law (HCR) at Section 9003 of the Patient Protection and Affordable Care Act (PPACA) repeals the tax-favored status of Over the Counter (OTC) drug purchases as of January 1, 2011. There is an exception.

Due to the prevalence of plans which include OTC drugs as a covered expense, we have prepared this update, based on [IRS Revenue Ruling 2010-23](#) and [IRS Notice 2010-59](#) (issued September 3, 2010) eliminating the tax-favored treatment.

Discussion

Applicability. This revision to what constitutes medical expenses applies to cafeteria plan's Health Care Spending Accounts, Medical Expense Reimbursement Plans, Health Reimbursement Accounts, as well as to Health Savings Accounts (HSAs) and Archer Medical Savings Accounts (MSAs) as of January 1, 2011.

The New Definition of Covered Medicines or Drugs. As of January 1, 2011, new IRC Section 106(f), applicable to employer-sponsored accident and health plans, provides favorable tax treatment for:

- Prescribed drugs (not available OTC);
- Prescribed drugs (available OTC but prescribed by a physician); and,
- Insulin.

The Notice also applies to Health Savings Accounts (amending IRC Section 223(d)(2)(A), and Archer Medical Savings Accounts (amending IRC Section 220(d)(2)(A))

Taxation. If a participant uses funds from his/her HSA or MSA for non-prescribed OTCs, the amounts used not only become income, but also will be subject to the 20% penalty tax. It is important to note that the penalty and income tax only applies to drugs purchased on or after January 1, 2011. OTC drugs purchased in December 2010, for example, the reimbursement through the FSA, HRA, HSA, or MSA account in January or later will not be taxable and no penalty will apply.



Definition of Prescribed Drugs. The IRS Notice also points out that IRC Section 213(d)(3) defines a prescription drug as a drug or biological that requires a prescription for its use by an individual. Until now, IRC Section 106(f) definition did include OTC drugs. HCR redefines IRC Section 106(f) to include written or electronic order for a medicine or drug that meets the legal requirements of a prescription in the state in which the expense occurs and issued by an individual who's legally authorized to issue a prescription in that state. As of January 1, 2011, neither definition will include non-prescribed OTC drugs or medicines.

DME. Durable medical equipment such as crutches, bandages, etc. do not qualify as drugs, but do qualify under IRC Section 213(d) under most circumstances as a medical expense (IRS reg. 1.213-1(e)(1)(ii) and are usually purchased with a prescription. The new law continues to permit this.

Debit Card Issue. Since debit card systems do not identify whether purchases are prescribed or not prescribed, the IRS Notice prohibits the use of debit cards after December 31, 2010 for the purchase of OTC drugs (whether prescribed or not prescribed). Individuals may still use debit cards for other medical expenses. The IRS provides a safe haven for the period from January 1, 2011 to January 15, 2011 with regard to drug-purchase substantiation. As of January 16, 2011, the IRS will require substantiation before a Health Care Spending Account or Health Savings Account or MSA provides reimbursement for OTC drug expenses. For purposes of this Rule, receipts must include the name of the purchaser (or the name of the person to whom the prescription applies), the date and amount of the purchase, and the Rx number.

Cafeteria Plan Amendment Required. Plan sponsors will need to amend their existing cafeteria plans (if the plan currently allows benefits for OTC drugs). The IRS proposed cafeteria plan rules ordinarily require all plan amendments to be prospective. As an exception, the IRS Notice provides plan sponsors with the ability to amend their cafeteria plans retroactively, but no later than June 30, 2011 with an original effective date of January 1, 2011.

Action Plan

1. Review all welfare plans which currently offer benefits for OTC drugs and medicines.
2. Prepare or request plan amendments to be prepared and executed prior to January 1, 2010.
3. If you have debit cards in your program, and if participants can use them for OTC drugs and medicines, consult with your benefits professional or debit card vendor regarding the cessation of qualified benefits and claim substantiation requirement as well as the control of debit card uses.
4. If your plan year is a calendar year, include this information in your election/enrollment materials for 2011. If open enrollment has already occurred, or if your plan year begins after January 1, 2011, provide a separate notice to plan participants regarding the change prior to January 1, 2011.



It is general in its nature and is no substitute for legal advice or opinion in any particular case.
mike@abferisa.com

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication, unless expressly stated otherwise, was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.

Unsubscribing. You are receiving this email as part of our retainer services with your company. If you would like to unsubscribe, please reply to this email by writing "unsubscribe" in the subject line.

