



Client Alert

Health Care Reform Series 2010

Changes on Over-the-Counter Drug Coverage Required Under Health Care Reform in 2011

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Over-the-counter medicines or drugs purchased without a prescription on or after January 1, 2011 (other than insulin) may no longer be paid for or reimbursed under health flexible spending arrangements ("health FSAs"), health reimbursement arrangements ("HRAs"), health savings accounts ("HSAs") or Archer Medical Savings Accounts ("Archer MSAs"). The IRS recently released [Notice 2010-59](#) and [Q&As](#), which provide further guidance on these changes made by the Affordable Care Act^[1] (the "OTC Changes"). The OTC Changes impact participant benefits under health FSAs, HRAs, HSAs and Archer MSAs on and after January 1, 2011, including the health FSA grace period for the 2010 plan year, and also affect the use of electronic debit cards. An arrangement's failure to comply with the OTC Changes may result in an adverse tax impact on participants. In addition, plan amendments may be required. The guidance discussed in this alert is generally effective January 1, 2011, although certain exceptions apply, as noted below.

OTC Changes only affect expenses related to medicines and drugs, and do not affect expenses incurred after December 31, 2010 for equipment (such as crutches), supplies (such as bandages), diagnostic devices (such as blood sugar test kits) and insulin. These expenses will continue to qualify for a tax-free reimbursement by a health FSA or HRA and for tax-free distribution from an HSA or Archer MSA, regardless of whether the items are purchased using a prescription.

Qualified Expense

Notice 2010-59 provides that in order for medicine or drug purchased after December 31, 2010 to be a qualified medical expense, the medicine or drug must satisfy one of the following:

- (1) it requires a prescription;
- (2) it is available without a prescription (an over-the-counter medicine or drug) and the individual obtains a prescription; or
- (3) it is insulin.

For these purposes, 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.

Impact on 2010 Grace Periods for Health FSAs

Because the OTC Changes are effective January 1, 2011, plan administrators should inform participants of the OTC Changes before the end of 2010 so that they understand that they will not be able to purchase nonprescription over-the-counter drugs (other than insulin) during the 2010 grace period (generally, January 1, 2011 through March 15, 2011) to exhaust monies remaining in their 2010 health FSAs, and avoid forfeiting them under the "use-it-or-lose-it" rule.

Participants may, however, be reimbursed tax-free after January 1, 2011 (e.g., during the health FSA's "run-out period") for over-the-counter medicines or drugs purchased without a prescription before January 1, 2011.

Failure to Comply

Amounts that are distributed from an HSA or Archer MSA for any medicine or drug that does not satisfy the requirements listed above will be includable in the participant's gross income and generally subject to a 20 percent additional tax. Although Notice 2010-59 does not address the issue, amounts that are paid for or reimbursed from a health FSA or HRA that do not satisfy the requirements listed above may cause the tax-preferred status of the entire health FSA or HRA to be jeopardized.

Impact on Use of Electronic Debit Cards

The new guidance also provides a transition period through January 15, 2011 during which the IRS will not challenge the use of health FSA and HRA debit cards for expenses incurred for over-the-counter medicines or drugs that are prescribed, or insulin, if the use of the debit cards complies with the existing guidance regarding the use of such cards.^[2] However, effective January 16, 2011, over-the-counter medicine or drug purchases at all providers and merchants must be substantiated before reimbursement may be made. Substantiation is accomplished by submitting the prescription (or a copy or other documentation that a prescription has been issued) for the over-the-counter medicine or drug, and other information from an independent third party that satisfies the requirements under Treasury regulations.

Because the health FSA and HRA debit card systems are currently incapable of recognizing and substantiating whether a medicine or drug is prescribed, the practical impact of this requirement is that such debit cards may no longer be used to purchase over-the-counter medicines or drugs that are prescribed on or after January 1, 2011, unless the store meets the 90 percent test (i.e., 90 percent of a store's gross receipts during the prior taxable year consists of items which qualify as expenses for medical care under I.R.C. § 213(d), which, solely for this purpose, will continue to include sales of over-the-counter medicines and drugs after December 31, 2010). Participants will need to submit paper claims for reimbursement of purchases where debit cards cannot be used. Debit cards may continue to be used for medical expenses other than over-the-counter medicines or drugs.

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 over-the-counter medicines or drugs that have been prescribed, if substantiation (as described above) is properly submitted in accordance with the terms of the plan.

Transition Rule for Retroactive Amendments to Cafeteria Plans

Notice 2010-59 provides that cafeteria plans may be amended retroactively as necessary to comply with the OTC Changes, provided the amendment is adopted no later than June 30, 2011.

^[1] The "Affordable Care Act" means The Patient Protection and Affordable Care Act (PPACA) and the Health Care and Education Reconciliation Act of 2010 (HCERA). For more information about the Act, please visit our Health Care Reform Task Force website at <http://www.proskauer.com/practices/health-reform-task-force>.

^[2] See Treasury regulations Section 1.25-6, Revenue Ruling 2003-43, Notice 2006-69, Notice 2007-2 and Notice 2008-104.