



Employee Benefits Law Action Memo

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Electronic Dispatch

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NEW GUIDANCE ISSUED ON THE COVERAGE OF OVER-THE-COUNTER MEDICINES AND DRUGS

The Internal Revenue Service (“IRS”) recently issued guidance on the new requirements for covering over-the-counter medicines and drugs (collectively, “OTC Drugs”) that generally will apply to employer-provided health plans and certain health accounts on January 1, 2011. Those requirements are summarized below.

Steps that employers should take to comply with the new requirements on OTC Drugs include:

- making sure that any employee who administers the applicable health plan or account is familiar with the new requirements;
- informing participants in the applicable health plans and accounts in 2010 about the new requirements, in order that they can (1) consider the new requirements for OTC Drugs when making health coverage elections for 2011, and (2) properly administer any tax-favored health accounts they have in 2010 with respect to expenditures for OTC Drugs;
- reviewing whether any amendments are needed to their health plan(s), health accounts, and cafeteria plan(s) to comply with the new requirements; and
- making any necessary changes to applicable summary plan descriptions, web pages, and other materials regarding the new requirements.

What Restriction is Imposed on the Coverage of OTC Drugs?

The Patient Protection and Affordable Care Act that was enacted on March 23, 2010 provides that a medicine or drug expense may only be paid or reimbursed by an employer-provided health plan, including a health flexible spending arrangement (“Health FSA”) and a health reimbursement arrangement (“HRA”), if:

- it is for a medicine or drug that requires a prescription;
- it is for an OTC Drug, and the covered individual has obtained a prescription for that OTC Drug; or
- it is for insulin.

This restriction on the coverage of an OTC Drug without a prescription (“OTC Drug Restriction”) also applies in the same general manner to a distribution from a health savings account (“HSA”) or an Archer Medical Savings Account (“Archer MSA”) for an OTC Drug.

For purposes of the OTC Drug Restriction, the new IRS guidance defines a prescription as “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.”

Does the OTC Drug Restriction Apply to Over-the-Counter Medical Equipment, Supplies, and Diagnostic Devices?

The new IRS guidance provides that the OTC Drug Restriction does not apply to medical care items that are not medicines or drugs, and therefore does not cover (among other things):

- equipment such as crutches;
- supplies such as bandages; and
- diagnostic devices such as blood sugar test kits.

If each piece of equipment, supply or diagnostic device satisfies the general tax requirements for medical care expenses (i.e., it generally must be an expense for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body), it still will be eligible for payment or reimbursement on a tax-favored basis as long as the terms of the applicable health plan or account permit such payment or reimbursement.

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What is the Effective Date of the OTC Drug Restriction?

The OTC Drug Restriction generally applies to OTC Drug expenses incurred after December 31, 2010. The IRS made clear in its new guidance that this December 31, 2010 effective date will apply even if an employer's cafeteria plan provides for reimbursement of qualifying expenses incurred in a 2½ month grace period after the end of a calendar year.

If an expense for an OTC Drug without a prescription is incurred in 2010, but is paid or reimbursed in 2011 in accordance with the terms of the applicable plan or account and pursuant to the applicable tax requirements, such payment or reimbursement will still be allowed. However, if an expense for an OTC Drug without a prescription is incurred after December 31, 2010, it generally may no longer be paid or reimbursed on a tax-favored basis.

As an exception to the general December 31, 2010 effective date described in the preceding two paragraphs, the new guidance provides that the IRS will not challenge the use of Health FSA or HRA debit cards for OTC Drug expenses incurred through January 15, 2011, if the use of the debit cards otherwise satisfies the applicable tax requirements.

What is the Amendment Deadline for a Cafeteria Plan That has to be Amended to Comply With the OTC Drug Restriction?

The new IRS guidance has a special transition rule for any amendment that may be needed to a cafeteria plan in order to comply with the OTC Drug Restriction. Although cafeteria plan amendments generally must be effective only prospectively, the new IRS guidance will allow a cafeteria plan to be amended for the OTC Drug Restriction by June 30, 2011, as long as that amendment is made effective retroactively for expenses incurred after December 31, 2010 (or January 15, 2011, for qualifying Health FSA and HRA debit card purchases).

May Health FSA and HRA Debit Cards be Used for OTC Drug Purchases Made After January 15, 2011?

The new IRS guidance generally provides that Health FSAs and HRA debit cards may not be used for OTC Drug purchases made after January 15, 2011, with a limited exception for "90 percent pharmacies" (a pharmacy will be a "90 percent pharmacy" if at least 90 percent of its gross receipts during the prior taxable year consists of items which qualify as expenses for medical care under the applicable tax requirements or as expenses for OTC Drugs) and where certain substantiation requirements are satisfied.

What Substantiation Requirements Will Apply to the Payment or Reimbursement of a Prescribed OTC Drug?

Before a prescribed OTC Drug that is purchased after the applicable effective date described above may be paid or reimbursed, it will need to be properly substantiated. Such substantiation includes submission of a copy of a prescription (or other appropriate documentation evidencing the prescription), and information from an independent third party that satisfies the applicable tax requirements (e.g., a customer receipt issued by a pharmacy that identifies the buyer, the date, the amount of the purchase, and the applicable Rx number).

If you have any questions about this memorandum, please contact Ted Lewkowicz in our Syracuse office (315-218-8131, tlewkowicz@bsk.com) or any of the other members of our Employee Benefits and Executive Compensation Practice Group listed below.

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