



IRS Releases Guidance on OTC Restrictions

The IRS has released important new guidance to help plan sponsors administer the restrictions on reimbursements for over-the-counter medications, which take effect January 1, 2011 regardless of plan year.

Background

Prior to the enactment of the health care reform law, employer health plans were allowed to cover over-the-counter (OTC) medications on a tax-favored basis. In practice, many account-based plans permitted such reimbursement, while most traditional medical plans did not.

The health care reform law added new provisions to the Internal Revenue Code that revise the definition of medical care and limit the ability of plans to reimburse many OTC items.

The IRS has now released [Notice 2010-59](#) and a series of [questions and answers](#) to provide guidance on how plans are to interpret this change in the law.

The Statutory Provisions

Under the new law, the cost of most OTC medications will not be eligible for reimbursement under medical plans, including health flexible spending accounts and health reimbursement accounts. (See our April 21, 2010 [For Your Information](#).) Similarly, these medications will not be allowed to be reimbursed on a tax-favored basis from health savings accounts and Archer medical savings accounts.

Reimbursements will generally only be available for the following –

- insulin
- OTC drugs prescribed by a physician
- OTC items that are not medicines or drugs, but otherwise meet the definition of medical care (e.g., crutches, bandages or blood sugar testing kits).

BUCK COMMENT. *Other than this limited list of examples, the guidance discussed below does not provide any information on what is or is not considered a medicine or drug.*

Clarifications in the Notice

The IRS notice provides several important clarifications to help plan sponsors and vendors come into compliance.

Effective Date. The limits on OTC medications are effective for all plans (regardless of plan year) on January 1, 2011. The notice clarifies that while plans may reimburse the cost of OTC drugs purchased in 2010 after

December 31, 2010, they cannot reimburse any newly-ineligible items purchased on or after January 1, 2011. This is true even for plans which utilize the grace period (i.e., permit the reimbursement of expenses incurred up to 2½ months after the close of the plan year from any balance remaining for that plan year). (See our June 30, 2005 [For Your Information](#).) Therefore, a calendar year health FSA that utilizes the grace period will not be able to reimburse ineligible OTC claims incurred during the grace period for the 2010 plan year.

BUCK COMMENT. *Employers with spending account plans that include a grace period or that are non-calendar year plans should consider a special communication to employees describing the impact of these changes for the current plan year.*

Section 125 Plan Amendments. Under regulations proposed several years ago, the IRS indicated that cafeteria plans generally may not be amended retroactively. This new notice gives plan sponsors until June 30, 2011 to adopt conforming plan amendments.

Definition of Prescription. Until now, it was unclear exactly what constituted a prescription for purposes of the new OTC restrictions. The notice clarifies that 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.”

Debit Card Systems. Many account-based plans utilize debit cards to reimburse eligible expenses. (See our December 20, 2006 [For Your Information](#).) The notice generally prohibits the use of debit card reimbursement for any OTC medications going forward, as current systems are unable to substantiate that the medications were validly prescribed. To help with the administrative transition, the IRS will not challenge the use of debit cards for OTC medications obtained prior to January 16, 2011. All OTC medications obtained on or after that date will be required to be substantiated as “by prescription” prior to reimbursement.

BUCK COMMENT. *One Q&A that was posted along with the notice indicates that an employee will be able to substantiate the expense by submitting a copy of the prescription along with a receipt showing the date of the sale and amount of the charge. The additional steps involved in obtaining a prescription and substantiating the claim will likely limit the attractiveness of spending accounts for OTC medications.*

Conclusion

Plan sponsors and their vendors now have important guidance on how to administer plans going forward. These details will be critical for communicating plan changes to participants in those programs which previously reimbursed OTC medications. Buck’s consultants would be pleased to assist you in taking the plan design, communication and administration steps necessary to comply with these new rules.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.