

Compensation & Benefits Law Update September 2003

Over-the-Counter Medications Covered by Health Care Flexible Spending Accounts

by Timothy C. McDonald

On September 3, 2003, the Treasury Department and the Internal Revenue Service ("IRS") announced that expenses for medications obtained over the counter and without a prescription can be reimbursed tax free under health flexible spending accounts ("FSAs") and health reimbursement accounts ("HRAs"). This is a significant development.

Background on FSAs and HRAs. Under a health FSA, an employee elects to contribute a portion of his/her salary on a pre-tax basis to an account. The balance of that account is then available to reimburse the employee for uninsured medical expenses that the employee incurs on behalf of the employee or the employee's dependents. Under the rules applicable to FSAs, the employee forfeits any balance remaining in his/her FSA at the end of the plan year.

Under an HRA, the employer makes an amount available to each participating employee to reimburse the employee for uninsured medical

expenses that the employee incurs on behalf of the employee or the employee's dependents. The employer can design the HRA so that any balance remaining in the employee's HRA at the end of the year is carried over and available to reimburse uninsured medical expenses that the employee incurs in subsequent years.

Amounts Paid to Reimburse Expenses for "Medical Care" Are Not Taxable. Whether a reimbursement plan is an FSA, an HRA, or some combination thereof, amounts received from the plan to reimburse the employee for medical expenses generally would not be taxed provided the employee incurred the expenses for the "medical care" (as defined under Internal Revenue Code § 213(d)) of the employee, the employee's spouse, or the employee's dependents. Previously, the consensus had been that the term "medical care" included prescription drugs but not medications available over the counter without a prescription. Revenue Ruling 2003-102, however, makes it clear

that amounts paid for over-the-counter medications also constitute expenses incurred for "medical care" that can be reimbursed on a tax-free basis under FSAs and HRAs.

What Does This Mean for Your FSA or HRA? Revenue Ruling 2003-102 could have a variety of implications for your FSA or HRA and you might want to consider taking the following steps.

Determine Whether You Want Your FSA or HRA to Cover Over-the-Counter Medications. You should determine whether you want your FSA or HRA to cover over-the-counter medications. Revenue Ruling 2003-102 *permits* an FSA or HRA to cover these expenses. Coverage of these expenses, however, is *not required*. You could decide that you do not want to cover over-the-counter medications under your FSA or HRA or that you want your FSA or HRA to cover only certain over-the-counter medications. Once you have determined how you want expenses for over-the-counter medications handled, you should modify your FSA or

HRA document to the extent necessary to reflect your intent.

Review Your FSA and HRA Plan Documents. You should review your FSA and HRA plan documents *as soon as possible* to determine what impact Revenue Ruling 2003-102 will have on your plan.

Some FSAs and HRAs define the expenses eligible for reimbursement by reference to Code § 213(d). If your FSA and/or HRA does this, then expenses that covered employees incur for over-the-counter medications might be covered automatically. If you do not want your plan to cover these expenses, you might need to amend your plan to exclude this coverage.

On the other hand, some FSAs and HRAs define the expenses eligible for reimbursement in a manner that would **not** automatically pick up expenses for over-the-counter medications. For example, in some cases, FSAs or HRAs cover expenses that the employee could *deduct* on his/her tax return under Code section 213 if the employee did not obtain reimbursement under the plan. In this case, the over-the-counter medications would **not** be covered under the plan as written. Despite the change made by Revenue Ruling 2003-102, an individual generally cannot deduct expenses for over-the-counter medications on his/her tax return. In these cases, you would need to amend your plan if you wanted the plan to cover expenses incurred for over-the-counter medications.

Review Your Procedures for Making Benefit Claims. An FSA or HRA can-

not reimburse an employee's expenses for medical care unless the employee properly substantiates payment of those expenses. If your plan covers over-the-counter medications, you will need to determine what evidence you will accept for proof of payment of those expenses. Dated receipts that adequately identify the product should be sufficient. Receipts that do not identify the product purchased or the date of purchase, however, would not provide proper substantiation. Therefore, this might be a good time to review your HRA and/or FSA claims procedures.

Identify Over-the-Counter Medications.

Under Revenue Ruling 2003-102, it is clear that a properly drafted FSA or HRA can reimburse an employee for the cost of aspirin and other pain relievers, cold tablets, allergy medicines, and antacids that the employee purchases over-the-counter. It also is clear that an FSA or HRA cannot reimburse an employee for the cost of over-the-counter items that simply promote general health, such as toothpaste, dietary supplements, or cosmetics. Unfortunately, there are likely to be many situations in which it will be less clear whether HRA or FSA coverage is permitted. For example, can an FSA or HRA reimburse an employee for the cost of herbal remedies, contact lens solutions, fiber supplements, throat lozenges, etc.?

Communicate with Employees.

Whether you decide to allow employees to receive FSA and/or HRA reimbursement for over-the-counter medications or not, you should address this issue with your employees. The change made by Revenue Ruling 2003-102 already

has generated some media attention. We also suspect that expanding your FSA or HRA to cover these expenses could be very popular with employees.

Revenue Ruling 2003-102 represents a significant change in the interpretation of the law governing HRAs and FSAs. If you have questions about how this new ruling will affect your plan, please contact one of the members of our Compensation & Benefits Section.

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