

Client Alert

A report
for clients
and friends
of the firm **October 2003**

IRS Authorizes Health Flexible Spending Accounts to Cover Over-the-Counter Drugs

The Internal Revenue Service has issued Revenue Ruling 2003-102 (the "Ruling"), which provides that health flexible spending accounts ("FSAs") and other employer-sponsored health plans may reimburse the cost of over-the-counter medicines.

Prior to the Ruling, a medical care expense was understood to be reimbursable under an FSA only if it would be deductible under Section 213 of the Internal Revenue Code. That section limits *deductions* to amounts paid for medical care pursuant to a prescription or for insulin. In the Ruling, however, the IRS concluded that a medical expense need not be deductible to be reimbursable under an FSA. The IRS reasoned that, because Section 213(d)(1) of the Code defines "medical care" to include amounts paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purposes of affecting any structure or function of the body," a treatment could be used for medical care even if available without a prescription and even if the associated costs would not be deductible under Section 213 of the Code. In a joint press release, the IRS and Treasury stated that the change was due in part to the migration of many prescription drugs to the over-the-counter market in recent years. It is important to note, however, that nonprescription medical care remains nondeductible.

Cold Medicines but not Vitamins

The Ruling notes that an expenditure that is "merely beneficial to the general health of an individual . . .

is not an expenditure for medical care." Accordingly, while antacids, allergy medicine, pain reliever and cold medicine may be reimbursed under an FSA, vitamins, dietary supplements, toothpaste and similar toiletries, cosmetics (such as face creams) and vacation-related expenses generally cannot be reimbursed. The universe of eligible nonprescription items is expected to be clarified over time. Questions remain about whether expenses for certain products, such as dandruff shampoo (which has both medical and cosmetic benefits) and condoms (disease prevention), may be reimbursed. The IRS has informally indicated that certain acne medications are reimbursable.

Absent further IRS guidance regarding what constitutes a legitimate over-the-counter medical expense for purposes of Section 213(d), employers will want to establish precise definitions of expenses incurred for medical care and any applicable restrictions. Employers may wish to enumerate classes of reimbursable products in the plan document or employee communications, or by reference to an external guide.

Additional questions include whether items can be purchased only for an illness that exists on the date of purchase (as opposed to a purchase of commonly-used medicine at a time that a participant and his dependents are symptom-free), and whether items purchased in bulk (*e.g.*, five cases of antacids) will be allowed. Employers will also want to consider the costs associated with administering over-the-counter reimbursements.

Substantiation

IRS officials have informally stated that reimbursement may be made for over-the-counter medicines only if a participant presents an original receipt indicating the date of purchase, the name of the item and its cost. The IRS has also informally indicated that submitting the box containing the medicine, or an affidavit signed by the employee, would not be considered proof of purchase.

Plan Documents and Communications

There is no *requirement* that employers enable their employees to receive reimbursements for over-the-counter medicines under their FSAs. Employers will need to determine whether to make such drugs reimbursable and then review their plan documents and participant communications (including the summary plan description) to determine whether the documents need to be revised to reflect their decision.

- For an employer who wishes to incorporate the new rule, if a plan permits reimbursement simply for “amounts incurred for medical care as defined in Section 213” or “amounts permitted by the IRS,” a plan amendment may be unnecessary and the employer may be able to simply notify its employees of the change in law. If the employer's plan specifically excludes reimbursement for over-the-counter drugs or permits reimbursement solely for items “that would otherwise be eligible for deduction under Section 213(a),” a plan amendment will be needed for participants to be reimbursed for the costs of non-prescription items.
- An employer who wishes to exclude nonprescription drugs from reimbursement under its FSA must ensure that the plan documents and related employee communications clearly so provide. If the plan as written would cover over-the-counter drugs, for example because it indicates that reimbursements are available “to the extent legally permissible,” the employer will want to consider amending the plan to clarify its terms.
- Employers will also need to review claims procedures to determine whether any modifications are necessary, and should consult with their plan administrators regarding whether they have established specific guidelines for these types of claims. In addition, plan administrators will want to highlight changes regarding nonprescription medical care expenses for employees during open enrollment.

Effective Date

Because the Ruling technically announces a clarification of the law rather than a new rule, employer-sponsored health plans that, by their current terms, would allow reimbursement of nonprescription items may permit participants to submit expenses incurred at any time during the plan year if they so wish. In contrast, plan documents that require amendment to permit such reimbursements should do so only prospectively. For administrative ease, many employers may wish to permit reimbursement of over-the-counter medications beginning only with calendar year 2004. Due to cafeteria plan rules, employees may not change their election whether to participate in an FSA during the middle of the year, irrespective of the Ruling.

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Client Alert

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