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FSA Reimbursements for Nonprescriptive Drugs

Recent legislation has changed the types of medical expenses that can be reimbursed through FSAs and other similar plans. Starting in 2011, over-the-counter drugs can only be eligible for reimbursement from an FSA if the individual has a prescription for the drug.

The Patient Protection and Affordable Care Act (P.L. 111-148) changed the definition of medical expenses that can be reimbursed through flexible spending arrangements (FSAs) so that over-the-counter drugs will no longer qualify. Beginning January 1, 2011, distributions from health FSAs, as well as health reimbursement accounts, will allow reimbursement of the cost of over-the-counter medicines or drugs (other than insulin) only if they are purchased with a prescription. A similar rule will apply to health savings accounts and Archer medical savings accounts. Employers and employees need to consider these new rules when determining the amount to contribute to these plans for 2011 and when using any remaining funds contributed for 2010.

Background

Health FSAs are employer-established benefit plans that may

be offered as part of a cafeteria plan that permits employees to pay for certain expenses using pre-tax dollars. They are usually set up as a salary reduction plan under which employees agree to have a portion of their compensation withheld and placed into an individual account maintained by the employer. These plans are very popular because they help employees budget for large medical bills by allowing participants to set funds aside over time through payroll deductions. Because amounts paid into the plan aren't included in the employee's gross income, they aren't subject to federal income tax or social security tax, thus resulting in tax savings for both employees and employers (exclusion varies among those states with state income taxes). After the employee pays for the qualified expense, the employer reimburses the employee out of the employee's account, effectively allowing the employee to pay for qualified expenses with dollars that haven't been subject to tax. The employer benefits because the savings from paying less social security taxes usually more than offsets the costs of administering the plan.

FSAs have what is referred to as a use-it-or-lose-it rule. This means

that any unused contributions remaining at the end of a plan year are forfeited. Some FSAs provide for grace periods of up to 2.5 months after the end of the year to incur qualifying expenses.

Health reimbursement accounts (HRAs) provide similar benefits, but they must be funded solely through employer contributions, and unused balances can be rolled over to the next year.

Health savings accounts (HSAs) and Archer medical savings accounts (Archer MSAs) provide similar benefits for individuals with high-deductible health plans. Contributions made by employers to these plans aren't included in the employee's income, and contributions made by individuals are deductible even if that individual only takes the standard deduction. Unused amounts can be rolled over to the next year.

The list of qualifying expenses that can be reimbursed through these accounts currently includes not only the same medical and dental expenses that qualify as itemized deductions, but it also includes over-the-counter drugs, such as pain relievers and allergy and cold medications, that don't qualify as itemized medical expenses. As of January 1, 2011, \$9003 of

the Act revises the definition of medical expenses for health FSAs, HRAs, HSAs, and Archer MSAs by restricting eligible medicines and drugs to amounts paid for prescribed drugs or insulin. The IRS recently issued Notice 2010-59 (2010-39 IRB 396) along with responses to a series of frequently asked questions in an effort to provide guidance on these changes.

Notice 2010-59

As of January 1, 2011, expenses incurred for medicines or drugs may be paid or reimbursed by a health FSA, HRA, HSA, or Archer MSA only if (1) the medicine or drug requires a prescription, (2) is available without a prescription (an over-the-counter medicine or drug) but the individual obtains a prescription, or (3) is insulin. Notice 2010-59 states that 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. The IRS clarified that the new rules don’t apply to medical expenditures that aren’t for medicines or drugs, including equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar test kits.

The IRS emphasized that beginning January 1, 2011, over-the-counter purchases of drugs or medicine must be substantiated before reimbursement can occur. To meet the new requirements, an individual could submit a customer receipt from a pharmacy if

the receipt specifies the name of the individual for whom the prescription applies, the date, the amount of the purchase, and the related prescription (Rx) number. Alternately, an individual could submit a third-party receipt that includes the date, amount of purchase, description of medicine or drug, and a copy of the related prescription.

Expenses incurred for over-the-counter medicines or drugs purchased without a prescription before January 1, 2011, may be reimbursed at any time, pursuant to the terms of the plan. But expenses incurred for over-the-counter medicines during an FSA’s grace period won’t qualify without a prescription.

For example, ABC Corporation’s health FSA plan has a 2.5-month grace period. Tony, an employee of ABC, has a balance of \$175 in his health FSA as of December 1, 2010. In December 2010, Tony spends \$80 for over-the-counter medicines and \$20 for bandages. In January 2011, Tony spends an additional \$65 for over-the-counter medicines and \$10 for bandages. He didn’t have a prescription for any of the medicines that he purchased. In February 2011, Tony files a claim for reimbursement from his FSA for the \$175 that he spent for over-the-counter medicines and bandages. Tony can be reimbursed for only \$110 of the \$175 claim that he filed. All of his December purchases qualify, but only \$10 of the January purchases qualify. The \$65 he spent for over-the-counter medicines in January isn’t eligible even though they were purchased dur-

ing the plan’s grace period. If Tony had a prescription for the over-the-counter medicines that he purchased in January, however, then he would be eligible for reimbursement from his plan.

Another aspect of the change will affect plans that issue debit cards that can be used to purchase medicines or drugs. The IRS acknowledged that current debit card systems are incapable of recognizing and substantiating when over-the-counter drugs are prescribed, so Notice 2010-59 states that the IRS won’t challenge the use of debit cards for expenses incurred through January 15, 2011, if they meet the current rules for use of debit cards as specified in the regulations and previous IRS notices. Debit cards must be reprogrammed by January 15, 2011, so that they can no longer be used to purchase over-the-counter drugs. To receive a reimbursement for any over-the-counter medicine or drug purchased after December 31, 2010, individuals will need to provide a copy of the prescription or the Rx number along with the name of the individual for whom the prescription applies and a receipt showing the amount and date of purchase.

Educating Employees

The changes made by the Patient Protection and Affordable Care Act mean that the definition of a medical expense for purposes of FSAs, HRAs, HSAs and Archer MSAs now conforms to the definition used for itemized medical expense deductions. Employees will no longer be able to receive reimbursement for over-the-counter

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drugs from their FSAs or similar plans without the added expense of a visit to the doctor to request a prescription and substantiation of the purchase. Confusion may reign in the early months of 2011 as individuals attempt to seek reimbursement for over-the-counter drugs under the prior rules unless employers educate their employees about these changes. **SF**

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