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**TO: Clients of Sitzmann Morris & Lavis Inc.**

**RE: Over-the-counter Drugs**

The Patient Protection and Affordable Care Act (PPACA) revised the definition of medical expenses as it relates to over-the-counter (OTC) drugs. On September 3rd the IRS published Notice 2010-59 and Revenue Ruling 2010-23.

**Revenue Ruling 2010-23** – This Ruling simply makes obsolete the earlier Revenue Ruling 2003-102, 2003-2 C.B. 559 that allowed medicines or drugs without a prescription to be excluded from gross income under § 105(b).

**IRS Notice 2010-59** – This Notice provides guidance on § 9003 of PPACA.

Effective Date: Applies after December 31, 2010. This effective date applies regardless of whether the plan year is fiscal or calendar, and regardless of any grace period for a health flexible spending arrangement (FSA).

Key Provisions:

PPACA added § 106(f) which revised the definition of medical expenses for employer-provided accident and health plans, including Sec. 125 FSAs and health reimbursement arrangements (HRAs). PPACA also revised the definition for health savings accounts (HSAs) and Archer medical savings accounts (Archer MSAs).

Under the new § 106(f), expenses incurred for a medicine or a drug shall be treated as a reimbursement for medical expenses under an employer-provided plan only if

1. The medicine or drug requires a prescription,
2. The medicine or drug is available without a prescription (an OTC medicine or drug) and the individual obtains a prescription, OR

3. It is insulin.

PPACA amends § 223(d)(2)(A) and § 220(d)(2)(A) to provide that for amounts paid after December 31, 2010, a distribution from an HSA or Archer MSA is a tax-free qualified medical expense only if the same conditions above are met. This does not affect distributions made before January 1, 2011, nor does it affect distributions made after December 31, 2010, for medicines or drugs purchased on or before that date.

Items that are not drugs or medicine. The rules in §§ 106(f), 223(d)(2)(A), and § 220(d)(2)(A) do not apply to items that are not medicines or drugs. For example, equipment such as crutches, supplies such as bandages, and diagnostic devices such as blood sugar kits, may still qualify if they meet the definition of medical care in § 213(d)(1). This definition includes expenses for the diagnosis, cure, mitigation, treatment, or prevention of disease.

FSA and HRA Debit Cards. Current debit card systems are not able to comply with the new § 106(f) because the systems are incapable of recognizing and substantiating that the medicines or drugs were prescribed. The IRS will not challenge the use of these cards for expenses incurred through January 15, 2011, if their use complies with pre-PPACA guidelines. On or after January 16, 2011, OTC medicine or drug purchases at all providers and merchants (regardless of whether they have an IIAS) must be substantiated before reimbursement may be made. Substantiation is accomplished by:

- Submitting the prescription or
- Submitting a copy of the prescription or
- Other documentation that a prescription has been issued, AND
- Other information from an independent third party that satisfies the requirements under Prop. Treas. Reg. § 1.125-6(b)(3)(i).

Example 1. A customer receipt issued by the pharmacy that identifies the name of the person for whom the prescription applies, the date and amount of the purchase and an Rx number.

Example 2. A customer receipt without an Rx number accompanied by a copy of the related prescription.

Transition Rule for Cafeteria Plan Amendments. Cafeteria plans may need to be amended to conform to the new OTC drug requirements. Normally amendments must be made prospectively. However, the IRS will allow an amendment to conform that is adopted no later than June 30, 2011, to be made effective retroactively for expenses incurred after December 31, 2010 (or after January 15, 2011 for FSA and HRA debit card purchases).

What's Next:

The IRS will amend the regulations under §§ 1.105-1, 1.10502, 1.10601, 1.125-1 and 1.125-5 to provide for the new definition of medical expenses. Taxpayers may rely on IRS Notice 2010-59 pending the issuance of the amended regulations.

Contact your SML Account team if you have any questions.