

In This Issue

In this McGraw Wentworth Special Alert, we will discuss the recently released IRS Revenue Ruling that allows for over-the-counter medications to be reimbursed by Flexible Spending Accounts. The Ruling will be popular with plan participants, especially those on medications that once required a prescription. However, plans need to address certain administrative concerns. The purchase of non-prescription medications is far less controlled than most services eligible for reimbursement under these plans. We will discuss plan concerns with covering these expenses.

We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or Account Director or visit the McGraw Wentworth web site at www.mcgrawwentworth.com.

“Special Alert: Over-The-Counter Drugs”

The IRS recently announced that employers may reimburse employees for certain over-the-counter medication costs through Flexible Spending Accounts, Health Reimbursement Arrangements and other employer provided health coverage. This news is exciting for many, but the ruling does not clarify the administrative issues involved in substantiating claims.



quire that deductible expenses under Section 105(b) be considered deductible under Section 213(b) or that only drugs requiring a physician’s prescription be taken into account.

The Ruling indicates that reimbursements for non-prescription drugs are deductible. The Ruling outlines a scenario in which an employee buys an antacid, an allergy medicine,

a pain reliever, and a cold medicine. The items are purchased to alleviate symptoms or treat the employee’s or an eligible dependent’s illness or injury. The employee submits substantiated claims for these over-the-counter products. Claims incurred within the plan year are reimbursed by the employer’s Flexible Spending Account.

The guidance suggests covered medications are not limited to antacids, allergy medications, pain relievers or cold medications. The only explicit exclusion is dietary supplements, such as vitamins, that are merely beneficial to the plan participant’s general health.

The Basics

This Revenue Ruling seems to conflict with recent IRS guidance on whether deducting over-the-counter medication costs is even permissible. Previous rulings state that medical care expenses are deductible as defined in Section 213(b) of the Internal Revenue Code. However, this section clearly states over-the-counter medications are not deductible.

The Revenue Ruling does not change the over-the-counter exclusion under Section 213(b). The Ruling instead addresses Section 105(b) of the Internal Revenue Code. Section 105(b) establishes that reimbursements from employer-provided health and accident plans are tax-free. The IRS states in the new Ruling that the Code does not re-

The Administrative Details

This Ruling was not unexpected. Now that so many popular medications, such as Claritin, are sold over the counter, many individuals end up paying more because these drugs are not covered under their employers' prescription drug programs. In a double whammy, employees discover they are also unable to recoup these expenses under their Flexible Spending Accounts.

The IRS was under tremendous pressure to address this issue. Because many more prescription drugs will soon be sold over the counter, the pressure would not abate.

The Ruling does create many questions and administrative concerns:

- **When is the Ruling effective?**

The Ruling does not include an effective date. The Ruling merely clarifies existing Code language. Plans can address the effective date in a number of ways:

- If your plan is sufficiently vague and does not specifically exclude over-the-counter medications, in theory, you could treat any claim submitted in this plan year as an eligible expense. Make sure your claims administrator agrees your plan document allows reimbursements for over-the-counter medications.

If your plan allows for coverage of these expenses retroactively because of vague plan language, employees who have not saved receipts for such



items may be upset that they were not told earlier that these expenses were covered, even though the IRS just released this clarification.

- If your plan document specifically excludes coverage for over-the-counter medications, you would need to amend it to indicate certain over-the-counter medications are covered expenses under the plan. The effective date of coverage would be the date the plan is amended.
- You may choose to amend

your plan at your next plan anniversary. This approach allows employees to make annual elections based on their understanding of the IRS guidelines

for covering certain over-the-counter medication expenses.

- **Can my employees increase annual elections under the Flexible Spending Account to take advantage of this Ruling?** Your employees can change their annual plan elections mid-year *only* when a qualified change in family status occurs. Different plans define family status changes in different ways, but under no circumstances can this IRS Revenue Ruling be construed as a qualified change in family status. Therefore, your employees **cannot** increase their annual elections mid-year because of this Ruling.
- **Which over-the-counter medications are excluded by this Revenue Ruling?** The

following items would not be considered eligible as over-the-counter medications under the Rule:

- **Dietary Supplements**-these include vitamins, energy drinks, energy bars and any product designed to promote health rather than treat an illness.
- **Toiletries**-these include toothpaste, mouthwash, dental floss, soap, deodorant, and so on.
- **Cosmetics** – these include face creams, moisturizers and make-up, as well as items used for cosmetic purposes such as Rogaine, Propecia and teeth-whitening treatments.
- **How does an individual submit a claim for these items?** Generally, an employee submits a receipt for services to substantiate a claim. In the case of over-the-counter medications the same is true. However, in order to qualify as eligible, the expense must be for medical care as defined in Section 213(d) for an eligible plan member. Informally, the IRS has indicated the following items would be considered adequate substantiation for over-the-counter medical expenses:
 - A store receipt that indicates the name of the drug purchased. The receipt must include the purchase date.
 - A participant certification that the medication purchased is being used to treat the medical condition of an eligible plan participant. The receipt doesn't need to include the

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NOTABLE THOUGHTS

EVERYTHING THAT IRRITATES US ABOUT OTHERS CAN LEAD US TO AN UNDERSTANDING OF OURSELVES.

CARL GUSTAV JUNG (1875-1961)

participant's name, and the IRS will accept this certification as a claim substantiation measure.

Ask your Third Party Administrator what information your employees will need to submit to substantiate these claims.

The Plan Concerns

This Revenue Ruling is exciting news for most plan participants. Your plan should keep in mind:

- **Clear Communication is Key:** When you inform your employees of these new eligible expenses, clearly identify:
 - The requirement that the participant certify the expense is for treating an eligible plan member's medical condition.
 - The documents necessary for the plan to process these claims.
 - Examples of what will be covered as an over-the-counter medication so your employees will understand what is covered by the plan and what is not.
- **Forfeitures May Be Reduced:** Many plans use year-end forfeitures to offset administrative costs. With this new Ruling, medical FSA forfeitures may be drastically reduced. Although the IRS may not

have intended it, plan participants may stock up on over-the-counter medications at year end to avoid losing any account balances.

Questions remain for plan administrators. If plan participants buy a case of Nyquil at year-end to avoid losing their account balances, will a receipt be sufficient to substantiate the claim? This Ruling blurs the definition of medical care. Although the Ruling requires the medication be purchased to treat a medical condition, it does not clarify whether the condition must be present before the medication is purchased. Could the medication be purchased before a medical condition arises? Clearly, anyone who buys a case of Nyquil would be expecting a medical condition to occur. Also, is there any test for reasonableness your administrator will use to manage the claim process more responsibly? A case of Nyquil is excessive. It may not be reasonable to assume it will be used to treat an imminent medical condition.

While the news is exciting, the potential administrative headaches may not warrant such excitement. The IRS is expected to clarify these administrative issues eventually, but no tentative date has been set.

Action Steps

Plan sponsors should take the following steps to cover non-prescription drugs under their flexible spending accounts:

- Determine whether your plan should cover over-the-counter medications. If necessary, amend the plan to cover these expenses.
- Tell your employees which



types of over-the-counter medications that are covered and explain that they must certify the expense is required for the treatment of a medical condition.

- Expect annual forfeitures to decrease under the medical Flexible Spending Accounts.
- Watch for further clarifications from the IRS.

If you have any question regarding this special alert, please contact your Account Director or Account Manager. **MW**

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