

Over the Counter Medicines Now Reimbursable Under Flexible Benefit Spending Accounts

On September 3, 2003, the Internal Revenue Service ("IRS") issued Revenue Ruling 2003-102, which allows over the counter medicines and drugs to be reimbursed by employers on a tax-free basis under health care reimbursement plans. This is a reversal of the earlier position of the IRS on tax-free reimbursement of over the counter medicines and drugs. The text of Revenue Ruling 2003-102 is available at <http://www.treas.gov/press/releases/js695.htm>.

Although the Revenue Ruling does not specify an effective date, the IRS, has informally advised us that whether the over the counter medicine and drug reimbursement is prospective or retroactive to an earlier date in 2003 depends upon the terms of the plan. Only if the plan is broadly drafted so that it does not have to be amended in order for the over the counter medicines and drugs to be reimbursed (unlikely in the case of most plans that have been drafted to reflect prior IRS guidance), can reimbursements for amounts purchased in 2003 prior to the date of the Revenue Ruling be made. However, the participants still must be able to document such earlier purchases of over the counter medicines and drugs with appropriate receipts.

If the plan is narrowly drafted, for example, it allows reimbursement for "prescription drugs only" or for "only those amounts deductible as medical expenses on the employee's federal income tax return," the plan will have to be amended in order to permit reimbursement of over the counter medicine and drugs. According to the IRS,

amending the plan to allow reimbursement of over the counter medicines and drugs is the equivalent of adding a new benefit mid-year; therefore, the reimbursement will be effective only on or after the date the plan is amended. It is unclear whether new elections of higher before-tax deferrals would be permitted following the addition of the new benefit mid-year. We are awaiting clarification from the IRS on this point. Until IRS issues such clarification, the conservative approach would be not to allow new elections under the plan on account of the new benefit.

The Revenue Ruling specifically finds medicines and drugs such as antacid, allergy medicine, pain relievers and cold medicine to be eligible for reimbursement. However, the Revenue Ruling also is clear that items used for general health or well-being, such as vitamins, dietary supplements, toothpaste and cosmetics are not medicines or drugs and thus are not reimbursable on a tax-free basis.

The administration of these new rules may prove to be challenging, at least initially. A plan that chooses to permit reimbursement of over the counter medicines and drugs should expect conflicting interests of plan administration and participants. For example, the Revenue Ruling is clear that items for general well-being, such as vitamins (and other dietary supplements) and cosmetics (*e.g.*, lotions and cold creams) are not reimbursable. However, disputes could arise if an employee requests reimbursement for vitamins or calcium supplements, for example, because a doctor recommended

the employee take the supplements, but did not prescribe them. The same could occur with certain creams or lotions, for example, if a doctor recommends a specific non-medical cream or lotion to be used for a skin condition.

Plans that elect to allow reimbursement of over the counter medicines and drugs should be prepared to draw some hard, non-negotiable lines as to what is, and what is not, reimbursable. We anticipate that general health items (vitamins, calcium supplements, other dietary supplements, creams, lotions, and similar items) will not be reimbursed, regardless of notes from a doctor recommending use, because such non-reimbursement reflects the specific terms of the Revenue Ruling.

Determinations also must be made as to what is an over the counter medicine or drug. For example, even though a cosmetic-like cream is marketed for treatment of acne, it likely should be regarded as an item used for general health or well being.

Employees also must understand that over the counter medicines and drugs are not deductible on the employee's tax returns even if reimbursable from a flexible spending account. The Revenue Ruling thus creates a new distinction between reimbursable medical expenses under flexible spending accounts and deductible medical expenses.

What should a company do if it intends to allow reimbursement of over the counter medicines and drugs? First, check the language in the plan to determine if it allows

such reimbursement or if amendments to the plan would be necessary. Second, contact the plan administrator or recordkeeper to determine when, and if, the administrator can process such reimbursement requests and the type of verification that will be required for reimbursement. Then provide guidance to plan participants.

We recommend that those companies that elect to permit reimbursement of over the counter medicines and drugs from their flexible spending account plans contact their plan administrators as soon as possible to identify reimbursable and non-reimbursable products and establish clear rules in advance of 2004 open enrollment. It also is likely that employees will be asking for such reimbursement in 2003. Such requests will come from employees who have unused amounts in their health care reimbursement accounts that are subject to forfeiture on December 31, 2003 if not used.

If you have questions about this Alert, please contact one of the attorneys listed below. ■

Key Attorney Contacts

| | |
|--------------|-------------------------------------|
| Thea Chester | 415/693-2139 tchester@cooley.com |
| Tom Reicher | 415/693-2381 treicher@cooley.com |
| David Walsh | 703/456-8021 dwalsh@cooley.com |
| Thomas Welk | 858/550-6016 twelk@cooley.com |

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2003 Cooley Godward LLP. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.