

Cafeteria Plans and Over-the-Counter Medications What Employers Can Do

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In what could prove to be a significant boost for health flexible spending accounts (FSAs), the IRS will now allow health flexible spending accounts ("FSAs") and other employer-provided health plans to reimburse employees for substantiated over-the-counter drugs. The ruling specifically concludes that such over-the-counter medications as antacids, allergy medicines, pain relievers, and cold medicines purchased without a doctor's prescription for a specific medical condition are medical expenses under the Internal Revenue Code. However, the ruling goes on to specify that vitamins taken "for general good health" do not count as medical expenses that can be reimbursed by a medical plan. These items are not deductible by individual taxpayers, but now can be reimbursed tax-free from their FSAs. The announcement can be found at the IRS web site at <http://www.irs.gov/newsroom/article/0,,id=112623,00.html> .

Employers will want to look closely at the definition of "medical expenses" eligible for reimbursement in their cafeteria plans. Some plans limit reimbursements to items that are deductible under Internal Revenue Code Section 213. These plans will not, without an amendment, permit reimbursement of over-the-counter medications. Slightly different, but now different in a critical way, is plan wording that defines "medical expenses" reimbursable by the plan as medical expenses as defined in Section 105 of the Internal Revenue Code. Under this wording, participants can now obtain reimbursements for over-the-counter drugs because the plan incorporates the section of the Internal Revenue Code that regulates what is a medical expense. Some plans use a definition of medical expenses as those set out in IRS publication 502 (it can be found on the internet at <http://www.irs.gov/pub/irs-pdf/p502.pdf>), says that people can include, in deducting medical expenses, prescription drugs, so implicitly limits such plans to reimbursement of prescription but not over-the-counter medications. In addition, plan sponsors need to review participant communications (summary plan descriptions, enrollment and claim forms, etc.). Participant communications may have become incorrect because of the change in the IRS position. For example, the summary plan description may state that participants can pay for prescription drugs from their Healthcare Spending Account, but cannot pay for over-the-counter medications. Depending on plan wording, that may now be incorrect. Once an employer knows what the plan requires currently, the employer should look at the future.

Plan sponsors have three choices for the future; depending on what the plan says now and what the employer chooses for the future, the plan and/or the summary plan description and enrollment/claim forms may need to be changed. Employers can choose to have the plan to limit expenses to prescription drugs: the advantage of this is

administrative simplicity. The past bright line for reimbursements stays in place. Over-the-counter medications are often inexpensive, so they will create a lot of paperwork for relatively small tax savings. Limiting reimbursement to prescription drugs would involve less paperwork, but still provide a tax benefit for the more expensive drugs. The disadvantage is that the employer is foregoing some FICA saving because the salary deductions for contributions to the cafeteria plan are not subject FICA and, from the employee's perspective, not subject to income tax either. Further, limiting reimbursements to prescription drugs could be perceived by employees as failing to help them take home as much of their paycheck as possible.

Second, employers can begin reimbursements for over-the-counter drugs immediately (claims could go back to January 1, 2003). Cafeteria plan sponsors could send out a notice soon, broadening the scope of reimbursements in the summary plan description to encompass over-the-counter medications. Employers that are very employee-oriented with its benefits, seeking to make benefits as user-friendly as is consistent with business needs, will find that this option achieves that goal. The advantage of this course of action is that it provides an additional value to the flexible benefit plan. There are disadvantages: there is no way to prove from the drug store receipt that an over-the-counter drug was purchased for a condition or particular person. Prescription drugs must be for a specific person and are usually for a specified condition. Not so with over-the-counter drugs: veterinarians may direct pet owners to give pets antihistamines, as an example. Plan administrators would need to find a way to limit reimbursements for over-the-counter medications to situations where participants have documentation substantiating the date of expenditure and the medication purchased. The requirement for a specific person and condition would have to be addressed in the claim form, and perhaps also in participant meetings. As to proof that the medication was taken for a specific medical condition rather than general good health, many employers will be conservative until the IRS gives more guidance, which might not happen for some time. A few types of medication could go on the presumptively not reimbursable list (maybe vitamins and herbs). Communications to participants could say something such as "The IRS will not permit reimbursements for over-the-counter medications for general good health. Such medications include vitamins and herbs. If you are taking any of these for a specific condition, the IRS will allow reimbursements. Please get a note from your healthcare provider indicating that he or she has recommended these for a specific medical condition. Please do not list the specific medical condition."

The third choice is to implement the reimbursement for over-the-counter medications effective January 1, 2004. This option has the advantage of allowing time for revisions of the summary plan description, claim form, etc., to describe this change. So this option allows the more liberal reimbursements, but on a more leisurely time line than the second option. It is possible that we will have the IRS's guidance on how to differentiate medications for a specific condition from those for general well being by January of 2004. Like the second option, this option has the disadvantage of creating for lots of small claims and more paperwork. Another disadvantage is that any

employees who forfeit part of their healthcare spending account for 2003 may feel that their employer could have avoided this result by allowing reimbursements for over-the-counter drugs in 2003.

Because many cafeteria plans are on a calendar year basis, many employers will be starting the preparation for open enrollment shortly, and will probably want to reach a decision on this matter in time to make revisions to enrollment materials.