



## Over the Counter Drugs Reminder: Amendment Due June 30, 2011

### **LEGISLATIVE BRIEF**

**June 24, 2011**

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The purpose of this Memorandum is to remind plan sponsors that, if the sponsor has an IRC Section 125 (Cafeteria Plan) with a health care spending account component, the sponsor must amend the plan no later than June 30, 2011 eliminating coverage for over-the-counter non-prescribed drugs and medicines (OTC) as of January 1, 2011 regardless of the plan year of the cafeteria plan. For those plans which were first implemented on or after January 1, 2011, we assume it did not contain this OTC benefit.

#### **Model Amendment**

To assist those plan sponsors who have not already amended their plans, we have enclosed a model amendment and a summary of material modification (SMM) for use in achieving compliance by the June 30, 2011 compliance date. Included in the Amendment is a second provision allowing for pre-tax contributions applicable to coverage provided to adult dependents. The Plan sponsor should include this provision if the cafeteria plan contains a premium contribution component. The following are links to the Amendment and to the Summary of Material Modification (for ERISA Plans):

- [OTC Amendment](#)
- [OTC SMM](#)

#### **Background**

As a result of the Health Care Reform Law (HCR) Section 9003, eliminating the non-taxable status of non-prescribed over-the-counter (OTC) drugs, the Internal Revenue Service (IRS) published [IRS Notice 2010-59](#) on September 3, 2010 eliminating the tax-favored treatment of OTC drugs as of December 31, 2010.

**Applicability.** This revision to what constitutes medical expenses applies to cafeteria plan's Health Care Spending Accounts, Medical Expense Reimbursement Plans, Health Reimbursement Accounts, as well as to Health Savings Accounts (HSAs) and Archer Medical Savings Accounts (MSAs).

## Discussion

1. **The New Definition of Covered Medicines or Drugs.** As of January 1, 2011, new IRC Section 106(f), applicable to employer-sponsored accident and health plans, provides favorable tax treatment for:
  - Prescribed drugs (not available OTC);
  - Prescribed drugs (available OTC but prescribed by a physician); and,
  - Insulin.
  
2. **Taxation.** The Notice also applies to Health Savings Accounts (amending IRC Section 223(d)(2)(A), and Archer Medical Savings Accounts (amending IRC Section 220(d)(2)(A). If a participant uses funds from their HSA or MSA for non-prescribed OTCs, the funds not only become income, but also will be subject to the 20% penalty tax, effective January 1, 2011. It is important to note that the penalty and income tax only applies to drugs purchased on or after January 1, 2011. OTC drugs purchased in December 2010, for example, and reimbursed through an HSA or MSA account in January will not be taxable and no penalty will apply.
  
3. **Definition of Prescribed Drugs.** The IRS Notice also points out that IRC Section 213(d)(3) defines a prescription drug as a drug or biological that requires a prescription for its use by an individual. IRC Section 106(f), however, previously included OTC drugs. IRC Section 106(f) now 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 expense occurs and issued by an individual who's legally authorized to issue a prescription in that state. Neither definition will include non-prescribed OTC drugs or medicines.

Even though prescribed durable medical equipment such as crutches, bandages, etc. do not qualify as drugs, but do qualify under IRC Section 213(d) under most circumstances as a medical expense (IRS reg. 1.213-1(e)(1)(ii).
  
4. **Cafeteria Plan Amendment.** Plan sponsors will need to amend their existing cafeteria plans (if the plan currently allows benefits for OTC drugs). The IRS proposed cafeteria plan rules ordinarily require all plan amendments to be prospective. The IRS Notice provides plan sponsors with the ability to amend their cafeteria plans retroactively, but no later than June 30, 2011 with an original effective date of January 1, 2011.
  
5. **Regulatory Conformance.** The IRS will be amending regulations to reflect the HCR Rule and the content of Notice 2010-59. The IRS also has issued [Revenue Ruling 2010-23](#) which repeals its earlier Revenue Ruling 2003-102 (allowing for OTC drugs as a covered expense.)

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