HEALTH CARE REFORM UPDATE: CHANGES IMPACTING ACCOUNT-BASED HEALTH PLANS

Employee Benefits Alert
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Practices & Industries

Employee Benefits

Introduction

Two important changes enacted as part of the Patient Protection and Affordable Care Act (PPACA) will require action by employers that sponsor health flexible spending accounts (health FSAs), health reimbursement accounts (HRAs), and high-deductible health plans coupled with health savings accounts (HSAs).

These changes are:

- The new rules regarding reimbursement of over-the-counter (OTC) medicines and drugs, which becomeeffective January 1, 2011, and
- The new definition of dependent child for purposes of non-taxable reimbursements from health FSAs and HRAs, which became effective March 30, 2010.

This alert incorporates guidance recently issued by the IRS in the form of Notice 2010-59 and related questions and answers regarding the reimbursement of OTC drugs and medicines from account-based and other group health plans. IRS Notice 2010-59 and the related questions and answers can be found at http://www.irs.gov/pub/irs-drop/n-10-59.pdf

This alert addresses each of these new developments in detail, including the implications for employers who sponsor account-based health plans.

New Rules Regarding Over-the-Counter Medicines and Drugs

Health FSAs and HRAs

Under new Internal Revenue Code § 106(f), added by PPACA effective January 1, 2011, medicine and drug purchases other than insulin qualify for tax-free reimbursement under health FSAs, HRAs, and other employer-sponsored health plans only if they are "prescribed." This means that OTC medicines and drugs that before PPACA could be reimbursed pre-tax without a prescription must now be prescribed to enjoy tax-favored treatment.

The new requirement applies to medicine or drug purchases made on or after January 1, 2011; health HSA and HRA claims for medicines or drugs purchased without a prescription on or before December 31, 2010, can be honored at any time, subject to the terms of the plan.

The January 1, 2011, effective date applies regardless of whether the plan year for the employer's plan is a fiscal or calendar year (or other coverage period in the case of an HRA), and regardless of any applicable grace period for a health FSA.

Health Savings Accounts

PPACA made comparable changes to the Internal Revenue Code provisions governing distributions from HSAs (Code Section 223). Thus, distributions from an HSA for a non-prescription medicine or drug expense incurred on or after January 1, 2011, will be subject to regular income tax and a 20 percent penalty unless the employee is eligable for Medicare or is disabled. Distributions after December 31, 2010, for eligible medicine or drug expenses incurred before January 1, 2011, will continue to qualify for tax-free treatment regardless of whether the medicine or drug is prescribed.

When Is a Medicine or Drug "Prescribed"

According to Notice 2010-59, a prescription is a "written or electronic order for a medicine or drug that meets the legal requirements of a prescription in the state in which the medical expense is incurred and that is issued by an individual who is legally authorized to issue a prescription in that state." Under New York State law, for example, written prescriptions must be issued on an official New York State prescription form that (among other things) identifies the name of the patient and the name and quantity of the drug and is signed by an authorized medical practitioner.

Note: The requirement that a medicine or drug be prescribed as a condition of tax-free reimbursement does not automatically impose upon an employer or third-party administrator the duty to request a copy of the prescription and confirm that it complies with a given state law, provided the employer (or third-party administrator) follows an alternative substantiation rule described in Notice 2010-59. This rule is discussed below.

Items Other Than Medicines and Drugs

The new rules do not apply to OTC items that are not "medicines or drugs." Items that are not medicines or drugs include medical supplies and equipment, such crutches and bandages, and diagnostic devices, such as blood sugar test kits.

Use of Debit Cards for OTC Medicines and Drugs

According to the IRS, current debit card systems are not capable of substantiating compliance with the new rules with respect to OTC medicines or drugs because the systems are incapable of recognizing and substantiating that the medicines or drugs were prescribed. Under IRS Notice 2010-59, the following rules apply with respect to the use of debit cards for this purpose:

Expenses Incurred Through January 15, 2011: In Notice 2010-59, the IRS advised that it will not challenge the use of a health FSA or HRA debit card for the purchase of a medicine or drug on or before January 15, 2011, if the use of the debit card complies with current guidance. Thus debit cards can continue to be used after the end of the year, but not beyond January 15, 2011. With the exception noted in the next paragraph, debit card vendors must reprogram their cards no later than January 15, 2010, to ensure that the cards may not be used to purchase OTC medicines or drugs after that date.

Expenses Incurred On and After January 16, 2011: Notice 2010-59 provides that, as a general rule, health FSA and HRA debit cards may not be used to purchase OTC medicines or drugs on and after January 16, 2011, regardless of whether the provider or merchant has an inventory information approval system (IIAS). However, until further guidance is issued, debit cards may continue to be used at any drug store or pharmacy if 90 percent of the store's gross receipts during the prior taxable year consist of items that qualify as expenses for medical care, provided substantiation of the medicine or drug purchase is properly submitted. The Notice provides that for the purposes of determining whether a drug store or pharmacy meets this 90 percent test, sales of OTC medicines and drugs at the store or pharmacy may continue to be taken into account after December 31, 2010.

Other Expenses: Debit cards may continue to be used for medical expenses other than OTC medicines or drugs. Thus, debit cards may continue to be used to purchase medical supplies and equipment, such crutches and bandages, and diagnostic devices, such as blood sugar test kits.

Substantiation of OTC Medicine or Drug Reimbursements

In the questions and answers accompanying IRS Notice 2010-59, the IRS addressed the manner in which employees could substantiate a purchase of a prescribed OTC medicine or drug as follows:

Q. How do I prove that I have purchased an OTC medicine or drug with a prescription so that I can get reimbursed from my employer's health FSA or an HRA?

A. If your employer's health FSA or HRA reimburses these expenses, you would provide the prescription (or a copy of the prescription or another item showing that a prescription for the item has been issued) and the customer receipt (or similar third-party documentation showing the date of the sale and the amount of the charge). For example, documentation could consist of a customer receipt issued by a pharmacy that reflects the date of sale and the amount of the charge, along with a copy of the prescription, or it could consist of a customer receipt that identifies the name of the purchaser (or the name of the person for whom the prescription applies), the date, the amount of the purchase, and a prescription number.

Thus, Notice 2010-59 and the Q&A provide two substantiation methods:

- The employee could provide a receipt from the pharmacy that identifies the purchaser (or the individual to whom the prescription was issued), the date, the amount, and the prescription number. Under this alternative, it appears the employee would not need to furnish a copy of the prescription and the employer/third-party administrator would not need to ensure that the prescription meets state law requirements, or

- The employee would provide an actual copy of the prescription instead of a receipt from the pharmacy (perhaps because the medicine or drug was not paid for at the pharmacy counter). Under this substantiation alternative, it would appear the employer (or third-party administrator) would need to ensure that the prescription meets the requirements for a prescription under the laws of the state in which the medicine or drug was purchased.

To simplify administration, many employers, especially those with employees in more than one state, will likely insist on the substantiation method outlined in the first bullet point.

New Tax Definition of Dependent Child

Under Internal Revenue Code § 105(b), reimbursements made to an employee under an otherwise qualified health FSA or HRA are not taxed to the employee if the expense is incurred by the employee, the employee's spouse, or the employee's dependents.

An individual is an employee's dependent for this purpose if he or she is the employee's qualifying child; the employee's qualifying relative; or, effective March 30, 2010, a child who is under the age of 27 as of the end of the employee's taxable year.

Reimbursements made for health expenses incurred by non-dependents of an employee are taxable to the employee.

Note: While many health FSAs and HRAs incorporate the dependent categories referenced above, they are not required to do so. In other words, in drafting its plan, an employer may narrow the categories of dependents covered by the plan subject, of course, to the age-26 mandate that applies to most HRAs and some health FSAs.

Qualifying Child

An individual is a "qualifying child" if the individual:

- Is the employee's child, sibling, step-sibling, or descendent of a child, sibling, or step-sibling,
- Is younger than the employee and unmarried,
- Lives with the employee for more than half of the year,
- Is a U.S. citizen, national, or resident, a resident of Canada or Mexico, or a child who is being adopted by a U.S. citizen or national whose household the individual shares,
- Does not provide more than 50 percent of his or her own support for the year, and
- Is age 18 or younger for the entire calendar year, age 23 or younger and a full-time student for the entire calendar year, or permanently or totally disabled at any time during the calendar year (regardless of age).

Qualifying Relative

An individual is a "qualifying relative" if:

- The individual is (a) the employee's "relative" or (b) is unrelated to the employee but lives with the employee for the entire calendar year as a member of the employee's household,
- The employee provides more than 50 percent of the individual's support during the calendar year,
- The individual is a U.S. citizen, national, or resident, a resident of Canada or Mexico, or a child who is being adopted by a U.S. citizen or national whose household the individual shares,
- The individual cannot be claimed by any other taxpayer as a qualifying child.

Special rules apply for children of parents who are divorced, legally separated, or living apart.

A Child Under Age 27

Effective March 30, 2010, an employee's child is a dependent for a calendar year if the child is under age 27 as of December 31 of that year. Thus, otherwise eligible expenses incurred by an employee's child who is under age 27 will qualify for tax-free reimbursement under a health FSA or HRA provided the expense is incurred on or after March 30, 2010. Expenses incurred by a child prior to March 30, 2010, would be reimbursable only if the child was a qualifying child or qualifying relative when the expense was incurred. Employers may rely on an employee's representation of a child's date of birth.

A child who qualifies as a dependent under this rule does not need to be a qualifying child or qualifying relative (defined above). As long as the individual is a child of the employee (defined below) and is under 27 as of the end of the calendar year, marital status, residency, support criteria and other dependency requirements are not relevant to the determination of whether eligible medical care expenses incurred by the individual during the year qualify for favorable tax treatment.

For the purposes of this rule, an employee's child is an individual who is one of the following:

- the employee's son or daughter (natural or adopted),
- a individual lawfully placed with the employee for legal adoption,
- the employee's stepchild, or
- an "eligible foster child," defined as an individual who is placed with the employee by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

Example: Smith is married to Jane, who has a daughter from a previous marriage. Jane's daughter is married, does not reside with Smith, and is gainfully employed, but will not be 27 or older as of December 31, 2010. Jane's daughter is Smith's dependent for health care purposes for 2010 because Jane's daughter is Smith's step-daughter and is under 27.

Example: Smith has legal guardianship of his 16-year old nephew. Althought the nephew may not be a child for purposes of the age-27 dependency rule, he may be a qualifying child (or qualifying relative) as defined above. It is important to note that a child (as defined above) who is age 27 or older at the end of a calendar year can still qualify as an employee's dependent if the child is permanently or totally disabled at any time during the calendar year (regardless of age) or is a qualifying relative.

Example: Smith's son James is 28 and is pursuing an advanced degree. James lives with Smith, and Smith provides more than 50 percent of James's support during the calendar year. James is not any other taxpayer's qualifying child. James is Smith's dependent for health care purposes because James is a qualifying relative of Smith.

Under IRS Notice 2010-38, employers that sponsor health FSAs and HRAs may for 2010 operationally extend the definition of dependent to include young adults under age-27, and for 2010 may operationally permit election changes under health FSAs to account for the new dependent definition provided conforming amendments are adopted by December 31, 2010. An employer's conforming amendment must be effective retroactively to the date of implementation.

Note that state tax laws do not necessarily follow federal law and, unless and until they do, employers will need to determine whether amounts reimbursed under a health FSA or HRA are taxable for state and local tax purposes.

Action Steps

New Dependent Child Definition

Employers should review current plan documents to determine whether the new category of young adult dependents is automatic. This may apply to plans that define dependent status by reference to Internal Revenue Code § 105(b).

If an employer's Health FSA or HRA does not automatically incorporate the new dependent definition and the employer wishes to adopt the new definition before the end of this year, the employer will need to adopt the amendment on or before December 31, 2010. The amendment must set forth the date on which it is effective (which, as noted, may not be earlier than March 30, 2010).

Employers who choose to implement the new rule on or after January 1, 2011 must adopt an amendment to the plan before the effective date.

Notice of the change must be communicated to employees (via the SPD or SMM for ERISA plans). This is critically important for plans that were drafted so that the new rule became automatically effective March 30, 2010.

New Rules Regarding the Reimbursement of OTC Drugs and Medicines

If an employer's health FSA or HRA currently allows for reimbursement of OTC drugs or medicines, the plan document must be reviewed to determine whether any year-end amendments are necessary to bring the plan into compliance with the new rules.

Employers should check with their third-party administraor to ensure that debit card systems are reprogrammed and that the administrator is prepared to employ new procedures to ensure that the new prescription requirement is satisfied.

Employers must also ensure that the new changes are accurately communicated to employees. Employers that maintain high deductible health plans in conjunction with HSAs should communicate these changes to affected employees.