



**Broker Fact Sheet**

# Health care spending account changes

The health care reform law changes rules for the following spending accounts:

- Health care flexible spending account (FSA)
- Health reimbursement arrangement (HRA)
- Health savings account (HSA)
- Archer medical savings account (MSA)

On September 3, 2010, the IRS issued Notice 2010-59, which provides more details about these changes. Here's what you need to know.

**Increased penalty for nonqualified HSA and MSA distributions**

The tax penalty on HSA and MSA distributions that are not used for qualified medical expenses is increasing from 10% to 20% of the disbursed amount. This change is effective for disbursements made during tax years starting on or after January 1, 2011.

**Prescriptions required for over-the-counter drugs (OTCs)**

Beginning January 1, 2011, members can use health care spending account funds for a medicine or a drug only if the medicine or drug is prescribed by a doctor (or another health care professional who is legally authorized to issue a prescription) in the state in which the OTC drug is purchased. The only exception is for insulin. The new standard applies to FSAs, HRAs, HSAs and MSAs.

The prescription requirement applies to OTC medicines and drugs purchased on or after January 1, 2011. This effective date applies to all plans, regardless of the plan year dates. This means that the rules will change in the middle of the plan year for all plans that are not calendar year plans (that is, a plan year that begins on January 1 and ends on December 31).

Members must follow these processes for expenses incurred on or after January 1, 2011:

<b>For health plan out-of-pocket expenses, vision and dental care</b>	<b>For insulin, whether prescribed or not</b>	<b>For OTC items that aren't drugs such as bandages and blood sugar testing supplies</b>	<b>For OTC drugs such as nonprescription allergy drugs, cold medicines and nicotine patches</b>
Members can continue to use spending account funds for these expenses.  They can pay by debit card or request reimbursement.*	Members can continue to use spending account funds for these expenses.  They can pay by debit card or request reimbursement.*	Members can continue to use spending account funds for these expenses.  They can pay by debit card or request reimbursement.*	Members can use spending account funds for these expenses <b>only</b> if they have a prescription.  FSA and HRA participants must pay up front and then substantiate the expense when they request reimbursement.

\*Request for reimbursement applies to FSAs only

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## Questions and answers

### **What happens if a participant uses HSA or MSA funds for nonqualified expenses?**

HSA or MSA funds used for nonqualified expenses will be taxable and will also be subject to a 20% IRS penalty, except for distributions made after the participant's death or disability if the participant is under age 65.

### **Will employers need to amend their plan documents? If so, when?**

If the employer has a cafeteria plan that allows members to use FSA and/or HRA funds for OTCs, the plan will need to be amended. Ordinarily, employers must amend in advance of such as change. However, IRS Notice 2010-59 allows for a transition period. An amendment made before June 30, 2011, to conform to the new requirement may be made effective retroactively for expenses incurred on or after January 1, 2011.

### **Do these rules apply to OTC items that are not medicines or drugs?**

These rules do not apply to OTC items that are not medicines or drugs, including equipment (such as crutches), supplies (such as bandages) and diagnostic devices (such as blood sugar test kits). Such items may qualify for reimbursement under a health care FSA if they otherwise meet the definition of medical care in Code Section 213(d).

### **Can members who purchase an OTC drug without a prescription this year be reimbursed next year?**

The prescription requirement applies to OTC medicines and drugs purchased on or after January 1, 2011. OTC drugs purchased in 2010 but submitted for reimbursement in 2011 (to the extent permitted) do not require a prescription.

### **Some customers have an FSA grace period. Can members use funds contributed in 2010 to purchase OTC drugs without a prescription in 2011?**

For health care FSAs that offer the 2.5-month grace period feature, OTC drugs purchased in 2011 can be reimbursed from 2010 account balances only if the participant obtains a prescription for those items.

### **How will members substantiate OTCs for which they have a prescription?**

Just like in the past, members will need to have an itemized receipt or similar third-party documentation that shows specific information for their purchase such as the date of purchase and purchase amount. After January 1, 2011, they'll also need to have one of the following for OTC drugs:

- The original prescription
- A copy of the prescription
- Another item that verifies a prescription has been issued – such as a pharmacy receipt that shows the name of the purchaser and a prescription number

FSA and HRA participants will need to submit substantiation documents to the spending account administrator before they can be reimbursed for an OTC drug purchase. HSA and MSA participants can be reimbursed from their account without providing these documents. However, the IRS may request substantiation, so participants need to keep documentation for their expenses.

### **What qualifies as a prescription?**

For this requirement specifically, the IRS defines a prescription as “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.”

All other current rules for health care spending accounts continue to apply. To see lists of qualified expenses, refer to IRS Publication 502: <http://www.irs.gov/pub/irs-pdf/p502.pdf> Note: These lists are *not* all-inclusive and are subject to change by the IRS. Consult your tax adviser if in doubt about a particular expense.