The Patient Protection and Affordable Care Act (also known as the “Affordable Care Act” or “ACA”) limits the items that may qualify as “qualified medical expenses” under flexible spending arrangements (“FSAs”) and health savings accounts (“HSAs”). Many CVS Caremark clients have asked us questions about these limitations.

Q1: How does the ACA impact the items that may be reimbursed under FSAs and HSAs?

The ACA modified the definition of "qualified medical expense" for purposes of HSAs and FSAs to be consistent with the IRS definition for medical expenses that an individual may take as a deduction on the individual's tax return. Specifically, Section 9003 of the ACA adds the underlined sentence to section 223(d)(2)(A) of the Internal Revenue Code (defining “qualified medical expenses” for purposes of HSAs):

- The term "qualified medical expenses" means, with respect to an account beneficiary, amounts paid by such beneficiary for medical care (as defined in section 213(d) for such individual, the spouse of such individual, and any dependent (as defined in section 152) of such individual, but only to the extent such amounts are not compensated for by insurance or otherwise. Such term shall include an amount paid for medicine or a drug only if such medicine or drug is a prescribed drug (determined without regard to whether such drug is available without a prescription) or is insulin.

Clients must seek their own, independent legal advice for authoritative guidance on this legislation and the questions below. This information is intended to be general guidance and is not intended as legal advice.

106-21510c 100510
Section 9003 of the ACA also adds a new section 106(f) to the Internal Revenue Code that contains similar language (defining “qualified medical expenses” for purposes of FSAs).

**Q2: What does this mean for individuals with FSAs or HSAs?**

It means that, in general, a drug/medicine can no longer be reimbursed from an FSA or paid for with funds from an HSA unless it is obtained pursuant to a prescription.

According to the new guidance issued by the IRS, under the new rules, only prescribed drugs/medicines (including OTC drugs/medicines that have been prescribed by a physician or other prescriber) and insulin (even if purchased without a prescription) will be treated as qualified medical expenses that can be reimbursed by a person’s FSA or paid for with funds from the person’s HSA.

**Q3: When does this change go into effect?**

According to the new guidance issued by the IRS, the change is effective for purchases of OTC drugs/medicines without a prescription after December 31, 2010. The change will not affect purchases of OTC drugs/medicines that occur in 2010, even if they are reimbursed after December 31, 2010.

Plan sponsors should be aware that the effective date of the new rules applies regardless of whether their plan has a fiscal or calendar year plan year, or whether an FSA “grace period” (as described in Q.6, below) applies to the plan. As a result, some plan sponsors may be required to begin compliance with the new rules in the middle of their plan years.

For example, assume Company X’s FSA plan has a plan year that begins on July 1. Company X will still be required to enforce the new ACA rules on purchases of OTC drugs/medicines effective on January 1, 2011, mid-way through the FSA’s plan year.

**Q4: How can an individual prove that he or she purchased an OTC drug/medicine with a prescription?**

According to the new IRS guidance, individuals may provide the prescription, a copy of the prescription or other evidence showing that a prescription for an OTC drug/medicine was issued, along with a customer receipt (or similar third-party documentation) in order to show that the drug/medicine was purchased. Under the new IRS guidance, to be valid, a prescription must meet the legal requirements for a prescription in the State in which the medical expense is incurred, and must be issued by a person who is legally authorized to issue prescriptions in that State.

Documentation proving that an OTC drug/medicine was purchased with a prescription might include a customer receipt issued by the pharmacy fulfilling the prescription (and which shows the date of the sale and the amount charged), that is accompanied by a copy of the original prescription. It might also consist of a pharmacy receipt that includes the name of the individual, the date and amount of the purchase, as well as the prescription’s Rx number.

*Clients must seek their own, independent legal advice for authoritative guidance on this legislation and the questions below. This information is intended to be general guidance and is not intended as legal advice.*
Q5: How are FSA and HSA plans that issue debit or credit cards to plan members to pay for medical expenses affected by the ACA requirements on OTC drugs/medicines?

Some FSA and HSA plans issue debit or credit cards to members that can be used to pay for qualified medical expenses. According to the new IRS guidance, current card systems cannot determine whether a prescription was provided for a purchase of OTC drugs/medicines. As a result, these sorts of debit and credit cards generally may not be used after January 1, 2011, to purchase OTC drugs/medicines. However, due to the significant systems changes that will need to be made in order to reflect the changes imposed by the ACA, the IRS will not challenge the use of debit or credit cards for purchases made through January 15, 2011. After that date, these kinds of debit and credit cards must be reprogrammed so that they can no longer be used to purchase OTC drugs/medicines.

Plan members who have a prescription for an OTC drug/medicine can still be reimbursed for purchases of such drug/medicine made without using the debit or credit card by providing evidence of the purchase and required prescription as described in Q.4, above.

Q6: How do the new rules apply to FSA plans that provide members with a 2 ½ month “grace period” following the end of the plan year during which the members can continue to use amounts left in their FSA accounts?

As noted above, the changes imposed by the ACA apply to purchases made on or after January 1, 2011. According the new guidance issued by the IRS, this means that, even if an FSA plan includes a 2 ½ month grace period, the cost of OTC drugs/medicines purchased without a prescription after January 1, 2011, will not be eligible for reimbursement under the FSA.

Q7: Are there any penalties for using funds from an HSA to purchase or reimburse the cost of OTC drugs/medicines?

According to the new IRS guidance, OTC drugs/medicines purchased without a prescription cannot be treated as “qualifying medical expenses” for HSA purposes. As a result, the cost of OTC drugs/medicines purchased without a prescription must be included in the member’s gross income, and is also subject to an additional tax of 20%.

Q8: Does ACA affect the reimbursement from an FSA or HSA of medical items other than drugs or medicines?

No, the rules governing medical care items other than drugs/medicines that qualify for reimbursement or payment from an FSA or HSA (e.g, bandages, eyeglasses, crutches, blood sugar test kits, etc.) remain unchanged. In addition, according to the new guidance issued by the IRS, FSA and HSA funds may still be used to pay copays and deductibles after December 31, 2010.

* * * * * * * * *