

BenAlert

BENEFIT TRENDS AND LEGISLATIVE UPDATES

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HOWITT
Benefit Services

Howitt Benefit Services is pleased to provide you with periodic updates on benefit trends and legislative updates. As part of our valuable services, we want to ensure that you are in compliance and well-informed of the ongoing changes in our industry.

In this BenAlert:

- Health Care Reform: W-2 Reporting Relief for 2011 and No OTC Drugs for FSA's and HSA's

On October 12, 2010, the Internal Revenue Service (IRS) announced in [Notice 2010-69](#) that it would make the reporting of employer-sponsored healthcare costs on Form W-2 OPTIONAL for the 2011 tax year. The W-2 disclosure requirement will become mandatory for the 2012 tax year in January 2013. The IRS has also issued a [draft 2011 Form W-2](#) that includes the codes that employers may use to report the cost of health care coverage.

Summary of the Law

By way of background, the Health Care Reform Law (HCR) will require employers to disclose the aggregate cost of the applicable employer-sponsored coverage for the calendar year (Tax Year) on Form W-2. The law was to take effect beginning with the 2011 tax year for employees participating in health plan coverage. It now will take effect with the 2012 tax year, reportable in January 31, 2013.

1. **Applicable Employer-sponsored Coverage.** For purposes of W-2 reporting, applicable employer-sponsored coverage has the following meaning:
 - All health care coverage (e.g. medical, dental, vision, EAP, chiropractic, etc.)
 - Whether insured or self-insured
 - Whether partially or fully paid for by the employer or employee
 - Excluding IRC Section 125 salary reduction contributions made to Health Care Spending Accounts, Long Term Care (such as the Unum products), Aflac-type target benefits (e.g. cancer/specific disease, hospital indemnity, etc.), or employer contributions to Health Savings Accounts or Archer medical Savings Accounts.

2. **Governmental Entities.** The same rules apply. Applicable employer-sponsored coverage includes coverage under a group health plan (as shown above) established and maintained by the U.S. government, the government of any state or its political subdivisions, or by any agency or instrumentality of such government.
3. **Self-employed Individuals.** For self-employed individuals (i.e. treated as employee under Internal Revenue Code (IRC) Section 401(c)(i)) health coverage under any group health plan will be treated as “applicable employer-sponsored coverage.”
4. **Determining the Amount.** The law itself (Section 9002(a)) says that the aggregate cost will be determined under Section 4980I(d)(1), rules which are similar to the rules of Section 4980B(f)(4) for determining applicable COBRA premium.

Why the Delay?

In Notice 2010-69, the IRS notice says it is providing the relief to allow employers additional time to make any necessary changes to their payroll systems or procedures in preparation for compliance with the reporting requirement. Consequently, employers will not incur any penalties for failure to comply with the W-2 reporting requirement promulgated by HCR for 2011.

The IRS expects to issue additional guidance on the W-2 reporting requirement by the end of this year. We will keep you informed of developments as they become available.

Health Care Reform: Over-the-Counter Drugs Gone – Almost

In 2003, the Department of Treasury/Internal Revenue Service issued a Revenue Ruling ([2003-102](#)) which has allowed group health plans including health FSAs, to provide benefits for non-prescription drugs and medicines purchased by plan participants. The Health Care Reform Law (HCR) at Section 9003 of the Patient Protection and Affordable Care Act (PPACA) repeals the tax-favored status of Over the Counter (OTC) drug purchases as of January 1, 2011. There is an exception.

Due to the prevalence of plans which include OTC drugs as a covered expense, we have prepared this update, based on [IRS Revenue Ruling 2010-23](#) and [IRS Notice 2010-59](#) (issued September 3, 2010) eliminating the tax-favored treatment.

Discussion

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) as of January 1, 2011.

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.

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))

Taxation. If a participant uses funds from his/her HSA or MSA for non-prescribed OTCs, the amounts used not only become income, but also will be subject to the 20% penalty tax. 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, the reimbursement through the FSA, HRA, HSA, or MSA account in January or later will not be taxable and no penalty will apply.

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. Until now, IRC Section 106(f) definition did include OTC drugs. HCR redefines IRC Section 106(f) to include 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. As of January 1, 2011, neither definition will include non-prescribed OTC drugs or medicines.

DME. 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) and are usually purchased with a prescription. The new law continues to permit this.

Debit Card Issue. Since debit card systems do not identify whether purchases are prescribed or not prescribed, the IRS Notice prohibits the use of debit cards after December 31, 2010 for the purchase of OTC drugs (whether prescribed or not prescribed). Individuals may still use debit cards for other medical expenses. The IRS provides a safe haven for the period from January 1, 2011 to January 15, 2011 with regard to drug-purchase substantiation. As of January 16, 2011, the IRS will require substantiation before a Health Care Spending Account or Health Savings Account or MSA provides reimbursement for OTC drug expenses. For purposes of this Rule, receipts must include the name of the purchaser (or the name of the person to whom the prescription applies), the date and amount of the purchase, and the Rx number.

Cafeteria Plan Amendment Required. 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. As an exception, 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.

Action Plan

1. Review all welfare plans which currently offer benefits for OTC drugs and medicines.
2. Prepare or request plan amendments to be prepared and executed prior to January 1, 2011.
3. If you have debit cards in your program, and if participants can use them for OTC drugs and medicines, talk to **Howitt** or debit card vendor regarding the cessation of qualified benefits and claim substantiation requirement as well as the control of debit card uses.
4. If your plan year is a calendar year, include this information in your election/enrollment materials for 2011. If open enrollment has already occurred, or if your plan year begins after January 1, 2011, provide a separate notice to plan participants regarding the change prior to January 1, 2011.

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