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From May through September this year the Internal Revenue Service has been extremely busy clarifying the categories of health care expenses eligible for itemized deductions and/or as reimbursement from Flexible Spending Accounts ("FSAs") and Health Reimbursement Arrangements ("HRAs"). Below is a summary of the two key rulings issued to date in calendar year 2003.

IRS Approves Equipment, Diagnostic Kits and Supplies As Eligible For Reimbursement in Health FSAs

In Revenue Ruling 2003-58 published on 5/15/03 (2003-22 IRB 959, 6/22/03), the IRS announced that amounts paid for nonprescription equipment, supplies such as bandages and diagnostic devices such as blood sugar tests, are deductible per Code section 213 and thus eligible for FSAs and HRAs without a physician's prescription.

In the Ruling's example, Taxpayer A had an injured leg and used crutches to enhance mobility relating to his need for medical equipment. A also used bandages to cover the torn skin on his leg. A's physician recommended that A take aspirin to treat his pain. A also has diabetes and uses a blood sugar test kit to monitor his blood sugar level. A was not compensated for his expenses by insurance or the employer.

Holding: Equipment (crutches), supplies (bandages) and diagnostic devices (blood sugar test kits, thermometers, etc.) qualify as medical care because Code section 213(d)(1) defines medical care as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. The IRS ruled that aspirin, available over-the-counter, does not qualify for itemized deductions (approved for FSAs and HRAs by Rev Rul 2003-102, see below). Insulin and saline solution continue to be eligible for reimbursement without a prescription.

IRS Approves Over-The-Counter Drugs As Eligible For Reimbursement in Health FSAs and HRAs

In Revenue Ruling 2003-102, published on 9/3/03 (2003-38 IRB, 9/22/03), the IRS announced that over-the-counter drugs are eligible for pre-tax treatment in Flexible Spending Accounts ("FSAs") and Health Reimbursement Arrangements ("HRAs"), but not for itemized deductions on an individual's tax return.

The Ruling noted that an employer sponsored a health flexible spending arrangement (health FSA). Employee A purchases an antacid, an allergy medicine, a pain reliever and a cold medicine from a pharmacy without a physician's prescription. The employee also purchases dietary supplements (vitamins) without a prescription. Employee A submits substantiated claims for all these expenses which have been incurred during the current plan year. The employee purchased these items for personal use, or use by his spouse or dependents, to alleviate or treat personal injuries or sickness.

Holding: Amounts spent by the employee to purchase over-the-counter medicine or drugs are expenditures for medical care. Employer reimbursements of those amounts are excludible from gross income under Code section 105(b) even though the cost would not have been deductible under Code section 213 (itemized deductions on a personal tax return using the 7.5% AGI Test). All the items purchased by the employee, except the dietary

supplement (vitamins), fell within the definition of medical care under Code section 213(d). The term "medical care" is defined as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. IRS regulation §1.213-1(e) states that expenditures for medicines and drugs are considered expenditures for medical care. However, toiletries (e.g. toothpaste), cosmetics (e.g., face creams), and sundry items are not medicines and drugs, and therefore not expenditures for medical care.

In distinguishing Rev Rul 2003-58, IRS considered whether amounts paid by an "individual" for nonprescription medicines were deductible under Code section 213 rather than a fringe benefit plan under Rev Ruling 2003-102. That ruling noted that section 213(b) permits the deduction only if the medicine or drug is a "prescribed" drug or insulin. Section 213(d)(3) defines a "prescribed drug" as a drug or biological that requires a prescription. Rev Rul 2003-58 holds that amounts paid for over-the-counter drugs or medicine are not deductible on a personal tax return.

In an IRS Press Release dealing with Revenue Ruling 2003-102 issued on September 3, 2003 Treasury Secretary John Snow stated: "Flexible Spending Accounts are an important tool in helping people meet their health care costs. Since many prescription drugs have moved to the over-the-counter market, this action today makes paying for them a little bit easier to swallow." IRS Commissioner Mark W. Everson joined in the Press Release stating: Flexible Spending Accounts were established under the tax code to provide incentives for better health care. This action is a sensible expansion and simplification of the program consistent with existing law."

Analysis of Revenue Rulings 2003-58 and 2003-102

Since these rulings were released, employers and participants have inquired about modifying their accounts, claim substantiation and whether expenses are eligible for reimbursement back to the beginning of the plan year.

Retroactivity: Yes. For plan years commencing in calendar year 2003, participants may submit claims for their expenses incurred during plan year 2003. TAI cannot, however, retrieve information from previously submitted claims.

Claim Substantiation: Yes. As with requests for health care reimbursement for prescription items, participants must submit copies of receipts, invoices, vouchers, credit card charges, canceled checks, etc. along with a TAI Claim Form, to receive reimbursement.

Modifications to Existing Health Care FSA: No. Participants will not be allowed to modify their current accounts to include expenses for over-the-counter drugs, equipment, diagnostics, etc. The rationale is based on the existing rules requiring a life event or family status change in order to modify a health care FSA. They are:

- Birth, adoption, change in the number of dependents, annulment, death, marriage, legal separation or divorce;
- Significant "group" plan benefit changes for you, spouse, dependents (e.g. Medicaid or Medicare, HIPAA election, custody); and
- Work hours, dependent or spouse's job gain or loss, or unpaid leave by either spouse or dependent.