The Patient Protection and Affordable Care Act (enacted on March 23, 2010 [PPACA] and amended on March 30, 2010, by the Health Care and Education Reconciliation Act of 2010 [HCERA]) substantially changed the rules surrounding the provision of health care. This chapter focuses on the impact of the new health care reform legislation on account-based health plans: flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), and health savings accounts (HSAs).

**Limits On FSAs**

Effective for taxable years beginning after December 31, 2012, employee salary reduction contributions under a cafeteria plan to a health FSA will be limited to $2500 per year. The December 31, 2012, effective date applies regardless of whether the cafeteria plan has a plan year that does not end on December 31. This $2500 per year limit will increase in future years (in $50 dollar increments) to reflect general cost of living increases – but not the cost of medical inflation.

This new limitation does not apply to other employee contributions under a cafeteria plan. This means that an employee’s cafeteria plan contributions used as pre-tax contributions toward medical premiums will not be subject to the annual dollar limitation; neither will employee contributions through a cafeteria plan for dependent care. Employer contributions to the health FSA are not counted toward the annual limit; therefore, an employer could add additional amounts to an employee’s cafeteria plan account, subject, of course, to the cafeteria plan nondiscrimination rules.
Over-The-Counter Drugs

Payment Or Reimbursement Of Medicines Or Drugs Is Limited To Prescribed Drugs, Insulin, And Over-The-Counter Medicines Or Drugs That Are Prescribed

PPACA changed current law to provide that reimbursements from employer-provided health plans (including health FSAs and HRAs) for expenses for medicines and drugs will only be treated as reimbursements for medical expenses (and thus, excludable from an employee’s gross income) if the medicine or drug is prescribed or is insulin.4 Similar changes were made to distributions from HSAs and Archer MSAs.5 These new restrictions are effective for purchases of over-the-counter drugs made after December 31, 2010. They do not affect purchases made in 2010 that are reimbursed after December 31, 2010.6

An individual will be able to be reimbursed for over-the-counter medicines and drugs as long as the individual obtains a prescription for the medicine or drug. For this purpose, IRS Notice 2010-59 defines “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.”

Importantly, these new requirements do not apply to items that are not medicines or drugs, including, for example, medical equipment such as crutches, medical supplies such as bandages, and diagnostic devices such as blood glucose (“sugar”) test kits. Items such as these will continue to be evaluated under the rules of Code section 213(d), which relate to expenses that qualify as medical care.

Debit Cards And Over-The-Counter Medicine And Drugs

The IRS has issued detailed guidance over the years to regulate health FSA/HRA debit cards used to purchase over-the-counter medicines and drugs in an effort to ensure that such purchases are properly substantiated medical expenses. The IRS initially took the position in 20037 that such purchases could not be made through non-pharmacy retailers such as grocery stores and, further, that all such purchases needed to be substantiated with a paper receipt. Three years later, in response to repeated requests from the public, the IRS developed guidance8 that established a complex method under which debit cards could be used at any store selling over-the-counter medicines and drugs without the requirement to substantiate purchases with a paper receipt. The IRS called this method the “Inventory Information Approval System” or “IIAS.” Debit card providers and merchants have devoted considerable resources over the years to build systems that satisfy the IRS’s stringent requirements, so that debit cards could be used in a wide variety of stores to purchase the full range of over-the-counter medicines and drugs.

Now that PPACA prohibits the reimbursement of over-the-counter medicines and drugs, except for the limited circumstances of over-the-counter medicines and drugs that are prescribed by a physician or insulin, the IRS will restrict the circumstances under which debit cards may be used to purchase over-the-counter medicines and drugs. Specifically, the IRS in Notice 2010-59 provides that:

• Current debit card systems generally are not designed to substantiate compliance with the new, narrower definition of reimbursable over-the-counter medicines or drugs. Therefore, with limited exceptions, the guidance currently provides that health FSA and HRA debit cards may not be used to purchase over-the-counter medicines or drugs on or after January 1, 2011.

• The IRS will not challenge the use of health FSA and HRA debit cards for over-the-counter medicines and drugs purchased through January 15, 2011, provided that the use of the debit card complies with existing IRS rules on debit cards.

• Under the pre-PPACA guidance, debit cards may be used at a pharmacy that does not have an IIAS provided that 90 percent of the pharmacy’s gross receipts during the prior taxable year consist
of items that qualify as medical care expenses under Code section 213(d). This new guidance provides that until further guidance is issued, debit cards may be used to purchase prescribed over-the-counter medicines and drugs at a pharmacy that satisfies the 90 percent test provided that the claim is properly substantiated in accordance with the terms of the employer plan and the cafeteria plan regulations. The guidance further provides that in order to determine whether the pharmacy satisfies the 90 percent test, sales of over-the-counter medicines and drugs may continue to be taken into account after December 31, 2010.

• Beginning January 16, 2011, purchases of prescribed over-the-counter medicines and drugs at all providers and merchants (other than 90 percent pharmacies), regardless of whether they have IIAS, must be substantiated before reimbursement may be made. An individual may substantiate that an over-the-counter medicine or drug has been prescribed, and thus, is eligible for reimbursement, by submitting the actual prescription (or a copy or other documents proving that a prescription has been issued) and the customer receipt or other third-party documentation that shows the date and amount of the purchase. For example, a purchase may be substantiated by submitting a customer receipt which identifies the name of the purchaser, the date and amount of the purchase, and an Rx number.

• Individuals may continue to use debit cards for other types of medical expenses.

It appears that the IRS may have intended for debit cards to be used to purchase over-the-counter medicines and drugs only in a 90 percent pharmacy because it is not clear that debit cards may be used in other circumstances, including, for example, a pharmacy counter in a retail store that does not qualify as a 90 percent pharmacy. Clarification on this important issue would be helpful.

Cafeteria Plan Amendments
The new definition of medical expenses may result in employers needing to amend their cafeteria plans. Normally, cafeteria plan amendments may only be effective prospectively. Notice 2010-59 provides relief from the prohibition on retroactive cafeteria plan amendments by allowing employers to adopt retroactive amendments to comply with the new rules relating to the change in the definition of medical expenses. Specifically, cafeteria plan amendments that conform with the requirements set forth in Notice 2010-59 that are adopted no later than June 30, 2011, may be retroactively effective for expenses incurred after December 31, 2010, or after January 15, 2011, for health FSA and HRA debit card purchases.

Increased Excise Tax On HSA Distributions
Distributions from an HSA or an Archer MSA are generally exempt from taxation if the distribution is used exclusively to pay qualified medical expenses. If the distribution is not used to pay for qualified medical expenses, the distribution is taxable to the owner of the HSA or Archer MSA, and an additional tax of 10 percent of the distribution is also imposed if the distribution is not used to pay for qualified medical expenses – with certain exceptions for distributions after death, disability, or attainment of Medicare eligibility age. Effective for distributions from HSAs and Archer MSAs made after December 31, 2010, the amount of the additional tax is increased to 20 percent of the distribution.

Excise Tax On High-Cost Plans
Effective for taxable years beginning after December 31, 2017, an excise tax of 40 percent applies to the aggregate value of employer-sponsored health plan coverage that exceeds a prescribed dollar amount. That amount is $10,200 for self-only coverage and $27,500 for family coverage. Any coverage under a multiemployer plan is treated as family coverage for purpose of the dollar limit. This dollar limit will be indexed annually (based on general cost of living increases). The dollar limit may be increased to reflect the age and gender of the population covered. The limit is also increased for retired, non-Medicare eligible individuals aged 55 to 64 and for individuals in a plan of an em-