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Re: Pretax Reimbursement of Over the Counter Drugs

Dear Clients and Other Friends:

In a surprise announcement, the IRS has ruled that nonprescription, over-the-counter drugs can now be reimbursed on a pretax basis from a health care flexible spending account ("FSA") under a cafeteria plan.

As many of you know, a growing number of drugs such as Claritin, are now available without a doctor's prescription. Under previous IRS guidance, nonprescription drugs, such as Claritin, could not be reimbursed from a cafeteria plan.

The IRS's ruling corrects a prior misapplication of the controlling statutes on the part of the IRS. Previously, the IRS took the position that a medical expense had to be eligible for a deduction under Code Section 213(a) in order to be reimbursed under a cafeteria plan FSA. A careful review of the controlling statutes, however, shows that this should not be the case.

The IRS's new position significantly expands the health care expenses that can be reimbursed tax free. For example, over-the-counter antacids, allergy medicines, pain and cold remedies, and perhaps even acne medications can now be reimbursed on a pretax basis.

The new rules are retroactive to the beginning of the 2003 plan year. In order to take advantage of the new rules, cafeteria plan documents may need to be amended and SPDs may need to be revised to permit such reimbursements. Since the new IRS position will benefit many employees, however, many employers will want to adopt the new rule as soon as possible.

If you have any questions regarding the new rule or need assistance in implementing the new rule, please contact one of us.

Very truly yours,

Anthony R. Battles

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