

September 2003

IRS Expands Allowable Reimbursements Under FSAs

In a series of recent rulings, the IRS has expanded the list of items and procedures which may be reimbursed with pre-tax dollars through health care flexible spending accounts ("FSAs"), health reimbursement arrangements ("HRAs") or other employer health plans.

Non-Prescription, Over-the-Counter Medicine and Drugs

The costs of non-prescription drugs may not be itemized as tax deductions under Code Section 213(b). However, in Rev. Rul. 2003-102, which was released on September 3rd, the IRS provides that the statutory exclusion for reimbursements of employee health care expenses from FSAs or other employer health plans is broader than the costs which may be deducted as itemized medical expenses. This clarification permits expenses for non-prescription, over-the-counter "medicine and drugs" (e.g., antacid, allergy medicine, pain reliever and cold medicine) to be paid with pre-tax dollars through FSAs or other employer health plans - even though such expenses are not deductible as itemized medical expenses. However, the costs of over-the-counter items that are not "medicine and drugs," such as dietary supplements (e.g. vitamins), toiletries (e.g., toothpaste), cosmetics (e.g., face creams) and sundry items, may not be paid with pre-tax dollars.

The IRS explains that the distinction between the reimbursable costs and non-reimbursable costs is whether the item is for "medical care" (i.e., 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) or is "merely beneficial to the general health" of the employee. FSAs and other employer

health plans may only reimburse the costs of "medical care" items. Accordingly, all reimbursement claims must be adequately substantiated.

Crutches, Bandages and Blood Sugar Test Kits

In another recent ruling, Rev. Rul. 2003-58, the IRS provides that the costs of equipment and supplies, such as crutches and bandages, which mitigate the effect of an injury, and diagnostic devices, such as blood sugar test kits, which monitor and assist in treating diabetes, may be deducted as itemized medical expenses. The qualification of these items as deductible medical expenses means that their costs may be reimbursed by FSAs or other employer health plans on a pre-tax basis.

Breast Reconstruction Surgery and Corrective Eye Surgery

In Rev. Rul. 2003-57, the IRS provides that the costs associated with breast reconstruction surgery which lessens a deformity directly related to a disease, and eye surgery to correct defective vision (including laser procedures such as LASIK and radial keratotomy), may be deducted as itemized medical expenses. The IRS explains that these costs may be deducted because they relate to procedures which treat a physical or mental disease or promote the proper function of the body. Since these costs are deductible, they may be reimbursed by FSAs or other employer health plans on a pre-tax basis.

In contrast, the IRS explains that procedures such as teeth-whitening to treat discoloration do not treat a physical or mental disease or promote the proper function of the body, but are rather directed at improving physical appearance. Accordingly, the cost of whitening teeth

may not be deducted as an itemized medical expense and is not reimbursable under an FSA or other employer health plan on a pre-tax basis.

What this Means in Plan Administration

The IRS' treatment of the items and procedures described above as expenses which may be paid for in pre-tax dollars does not mean that FSAs and other employer health plans must cover them. It merely means that such plans may elect to cover them. In light of this new IRS guidance, employers should take the following actions:

1. Review plan documents and summary plan descriptions. Determine whether the new allowable items and procedures may or may not be covered under their current terms. Plan amendments and participant notices may be required to properly reflect the employer's choice to cover or not cover the new allowable items and procedures. From a timing standpoint, some employers may wish to amend their plans right away in order to provide employees with additional ways to utilize FSA accounts before the end of the plan year. Others may choose to roll-out these changes in conjunction with open-enrollment for the 2004 plan year.
2. If an employer elects to cover the new allowable items and procedures, the claims substantiation procedures under its FSA or other employer health plan should be reviewed. The distinctions made by the IRS between allowable items and non-allowable items require specific descriptions. Accordingly, employers must ensure that their procedures require proper documentation, e.g., receipts which adequately distinguish between allowable "medicine and drugs" and non-allowable items, such as dietary supplements, to substantiate claims for reimbursement. The burden of plan administration will likely increase if greater substantiation is required. For employers who use a third-party administrator to handle FSA claims, timing of implementation of the procedures will need to be discussed and modification of current administrative services agreements and related documents/forms may be necessary.

If you have any questions about the application of this new guidance to your plan, please contact the Seyfarth Shaw employee benefits group attorney with whom you work or any employee benefits group attorney listed on the website at www.seyfarth.com

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E., Suite 700
Atlanta, Georgia 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

Two Seaport Lane, Suite 300
Boston, Massachusetts 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

55 East Monroe Street, Suite 4200
Chicago, Illinois 60603-5803
312-346-8000
312-269-8869 fax

HOUSTON

700 Louisiana Street, Suite 3850
Houston, Texas 77002-2731
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza
2029 Century Park East, Suite 3300
Los Angeles, California 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas, Suite 2500
New York, New York 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall, Suite 2350
Sacramento, California 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

101 California Street, Suite 2900
San Francisco, California 94111-5858
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W., Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32)(2)647.60.25
(32)(2)640.70.71 fax

This newsletter is a periodical publication of Seyfarth Shaw and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. For further information about these contents please contact the Firm attorney with whom you regularly work.