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IRS provides much needed coronavirus (COVID-19) related relief for cafeteria plans and flexible spending arrangements

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On May 12, 2020, the IRS released Notices 2020-29 and 2020-33 providing for relaxed cafeteria plan mid-year election change rules and expanded grace periods for health and dependent care flexible spending arrangements ("FSAs"). In addition, the new IRS guidance also provides for annual indexing of the dollar amount that can be carried over under a health FSA, clarified high-deductible health plan administration in light of recent guidance and legislation related to COVID-19, and explained reimbursement timing under health reimbursement arrangements ("HRAs"). Plan sponsors beleaguered by coronavirus have been asking for more flexibility in managing their health plans and FSAs during the pandemic, and the new IRA guidance provides that. This new guidance and practical considerations are described below.

Cafeteria plan election changes

In the normal course of health and welfare benefit plan administration, employees are typically able to make elections through a cafeteria plan (as defined in Section 125 of the Internal Revenue Code) to have their compensation reduced, on a pre-tax basis, to pay for their share of eligible benefits or to contribute to health or dependent care assistance flexible spending arrangements ("FSAs"). These elections are generally required before the start of the plan year (most commonly, cafeteria plans use a calendar plan year), but new eligible employees may make elections shortly after becoming eligible for the plan. Importantly, cafeteria plan elections are irrevocable for the duration of the plan year, except that the cafeteria plan rules allow plans to permit mid-year election changes upon certain life events (e.g., change in marital status, change in number of dependents, employment changes, etc.).

In connection with the COVID-19 crisis, many employers and plan administrators found it difficult to apply existing cafeteria plan mid-year change rules to situations where an election change may be in the best interest of participants. For example, many employers reduced employee hours, but maintained health coverage for these employees. As a result, employees may have found the health coverage to be too expensive in light of the reduced pay. A reduction in pay alone is generally not a mid-year change event that would allow a cafeteria plan participant to change an election. Also, as the COVID-19 crisis worsened, several insurance carriers and plan sponsors sought to offer a new plan enrollment window to employees who previously declined coverage. However, under existing cafeteria plan rules, such enrollment would only be available if employees paid for coverage on an after-tax basis (in the absence of a life event). Additionally, with many health care facilities suspending elective procedures, many health FSA participants may have made elections in anticipation of health expenses that they may no longer incur in 2020.

Responding to sponsors' concerns in Notice 2020-29, the IRS relaxed the cafeteria mid-year election rules to allow the following election changes during the 2020 calendar year:

- A new prospective election to enroll in a group health plan when the employee initially declined coverage.
- A prospective election change to move from one group health plan coverage option to another option.
- A prospective election to revoke coverage under the group health plan, provided that the employee attests in writing that the employee is enrolled or will immediately enroll in other health coverage (e.g., through a spouse's plan or on the ACA marketplace).
- A new prospective election, or a prospective modification or revocation of an election, under a health FSA.
- A new prospective election, or a prospective modification or revocation of an election, under a dependent care FSA.

Employers evaluating whether to allow these election changes should consider a few things. First, with respect to item 3 noted above, an employer is permitted to rely on an employee's written attestation unless the employer has actual knowledge that the employee is not and will not enroll in other comprehensive health coverage. Notice 2020-29 provides a model attestation statement.

Second, as with any other cafeteria plan mid-year change event, employers are not required to allow these new election changes. Indeed, there are reasons why employers may want to restrict application of the new rules. One reason is that allowing employees to move from one coverage option to another encourages adverse selection. For example, suppose an employee enrolled in a "low-plan option" that has a 25% coinsurance requirement, but that the employer also has a "high-plan option" (that has a higher employee premium) with a 10% coinsurance requirement. If circumstances change such that the employee anticipates significantly more medical expense than originally thought, the employee could switch to the high-plan option to cover medical expenses and then later drop back down to the low-plan option when the better coverage is no longer needed. To mitigate against this risk, employers could only allow one election change under the new IRS rules or could limit the new rules to new enrollments or modifications to improve coverage. In the fully insured context, employers should check with the insurance carrier to ensure the carrier will accommodate these election changes.

Similarly, employers should consider limiting election changes under FSAs to those accounts that are not overspent at the time of the election change. Notice 2020-29 specifically allows for this restriction.

Third, even if a cafeteria plan does not allow mid-year election changes, the HIPAA special enrollment rules still apply. Under those rules, employers and plan administrators must let eligible employees enroll themselves and/or eligible dependents upon certain life events if notice is provided within a specified period. Note that recent coronavirus-related relief requires that the special enrollment notice period be suspended during the public health emergency.

Cafeteria plans will need to be amended to reflect addition of these mid-year change events. The deadline for amending plans to reflect adoption of these changes is December 31, 2021. Importantly, those plan sponsors that permitted mid-year changes before the issuance of this IRS guidance with the hope that the IRS would eventually relax the cafeteria plan rules are covered by this relief retroactive to January 1, 2020. Those sponsors must still amend their plans to reflect the changes made to the mid-year elections and their plans' operations must be consistent with the IRS guidance.

Expanded grace period for health and dependent care FSAs

A defining feature of FSAs is the "use-it-or-lose-it" rule that provides that any FSA balances that are unused by the end of the plan year are forfeited. There are, however, exceptions to that rule. Both health and dependent care FSAs may apply a "grace period" during which unused FSA balances can be used to reimburse expenses incurred up to March 15 of the following year. Additionally, in IRS Notice 2013-71, the IRS permitted health FSAs (but not dependent care FSAs) to carry over up to $500 in unused funds to the following year. Notice 2013-71 provided that FSAs could allow either a grace period or a carryover, but not both.

The IRS guidance issued this week allows FSAs to be amended to extend any grace period ending in 2020 to December 31, 2020. This means that for calendar year plans, unused balances from 2019 for which a grace period would have ended on March 15, 2020, can now be applied to expenses incurred through December 31, 2020.

For plans that have a carryover feature rather than a grace period, the new IRS guidance allows these FSAs to be amended to permit both a carryover and a grace period (up to December 31, 2020) for the 2020 plan year. For example, in an FSA that normally permits a carryover, up to $500 can be amended to keep this carryover feature and allow any unused 2019 funds in excess of that $500 to be used for claims incurred in 2020.

The practical utility of the extended grace period rules during the COVID-19 crisis seems limited, particularly for calendar year plans. As a result of the coronavirus crisis, many FSA participants may find that their 2020 contributions, not their 2019 contributions, are at risk of forfeiture under the use-it-or-lose-it rule. Elections may have been made in anticipation of elective procedures in 2020 that have been cancelled, or in the expectation that their dependents would be in daycares or summer camps that are now closed. These expected expenses may never be incurred in 2020. Although the IRS guidance is a step forward in providing effective relief, these changes would be most helpful if permitted through December 31, 2021. As discussed above, sponsors can amend their plans to permit participants to revoke their elections prospectively. However, the amounts already accumulated in the FSAs might be subject to forfeiture without further relief.

FSAs that adopt these changes will need to be amended to reflect them no later than December 31, 2021.

Other changes

IRS Notices 2020-29 and 2020-33 also provided additional guidance related to annual indexing of the health FSA carryover amount, high-deductible health plans ("HDHPs"), and reimbursement timing for HRAs. This guidance is summarized below.

Health FSA carryover limit

As noted above, IRS Notice 2013-71 permitted carryovers of unused contributions up to $500 (20% of the annual contribution limit at the time). The annual health FSA contribution limit is adjusted annually by the IRS, but the maximum carryover amount has never been adjusted. IRS Notice 2020-33 provides that for carryovers attributable to 2020 (i.e., those that carry over to 2021), the maximum carryover amount will be $550. This amount may be adjusted by the IRS annually going forward. FSAs that adopt annual adjustment of the carryover limit to correspond with the IRS adjustment have until December 31, 2021, to amend the FSA to reflect the change for 2020. If this change is first adopted for plan years after 2020, the plan must be amended by the end of the year in which the carryover will first apply (e.g., an amendment to add the indexing feature starting with 2022 contributions must be adopted by December 31, 2022 in a calendar year plan).

HDHPs and COVID-19 testing and treatment

Prior IRS guidance (Notice 2020-15) provided that HDHPs would not fail to be health savings account ("HSA") eligible if the HDHP covers coronavirus-related testing and treatment before satisfaction of the statutory minimum deductible. The new IRS guidance clarifies that this rule applies to any pre-deductible coverage for expenses incurred on or after January 1, 2020. Additionally, the IRS guidance provides that testing for other health conditions to rule out COVID-19 (such as tests for the flu, norovirus or other coronaviruses, or other respiratory viruses) may also be covered prior to satisfaction of the statutory minimum deductible.

HDHPs and telehealth

The CARES Act included a provision allowing HDHPs to remain HSA-eligible if they provide pre-deductible coverage for telehealth or other remote care services. The CARES Act provision was effective on March 27, 2020, and applies to plan years beginning on or before December 31, 2021. The new IRS guidance provides that HDHPs will remain HSA-eligible if they provide pre-deductible coverage for telehealth and remote care services beginning on January 1, 2020, through the end of plan years beginning on or before December 31, 2021.

Premium reimbursements under HRAs

In the case of an HRA, medical expenses are typically considered incurred when the medical services are performed, not when they are billed or paid. In IRS Notice 2020-33, the IRS clarified how this rule applies to premium reimbursement arrangements or individual coverage HRAs that reimburse participants for premiums paid. The IRS guidance states that an HRA may treat premium expenses as incurred on (1) the first day of each month of coverage on a pro rata basis, (2) the first day of the coverage period, or (3) the date on which the premium is paid. This means that an HRA may reimburse expenses paid in a prior year for coverage in the current year.

The new IRS guidance related to cafeteria plans, HDHPs, and HRAs covers several administrative issues, and employers and plan administrators should consider the financial impact of making the changes as well as the administrative challenges they present. When considering the extent to which these changes will be applied under their cafeteria plans, employers and plan administrators should consult with benefits counsel.

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