IRS Will Allow Employees to Drop Employer Coverage Midyear, To Move to a Public Insurance Exchange

The Internal Revenue Service (IRS) has proposed modifications to the rules governing midyear changes to health plan enrollment elections under Tax Code Section 125 “cafeteria plans.” The proposed rules would allow an employee, during a plan year, to drop employer health coverage and purchase a policy on a public health insurance exchange (also known as a marketplace) under limited but not uncommon circumstances.

Generally, an employee paying premiums on a pre-tax basis under a cafeteria plan may not make coverage changes during the plan year unless he or she has a specific “change in status” or other qualifying event specified in IRS regulations. The IRS’s newly proposed rules would expand the list of such events, and allow an employee to drop employer coverage midyear and buy coverage on an exchange in the following instances:

- **Reduced hours during stability period.** An employee has his or her hours reduced, and as a result of the financial hardship would like to drop employer coverage and move to an exchange, even though he or she has not lost eligibility under the employer’s health plan.

- **Acquisition of a new dependent, or other public health insurance exchange “special enrollment event.”** An employee gets married, has a baby or adopts a child, and wants to drop employer coverage and move to the exchange (or the employee qualifies for exchange-based coverage due to becoming a U.S. citizen, national or lawfully present alien, or due to a permanent move).

- **Exchanges’ annual open enrollment.** An employee who is covered under a non-calendar year employer plan wants to drop coverage midyear and move to exchange coverage during the exchanges’ annual open enrollment period.

Like existing change in status and similar qualifying events, employers are permitted, but not required, to implement the new rules. However, we expect most employers to embrace the new proposal.

**Background: The Disconnect Between Section 125, the Employer Mandate and Insurance Exchange Enrollments**

As noted above, Tax Code Section 125 locks in the health insurance coverage elections of employees who pay for coverage on a pretax basis. The elections must remain in effect for the
entire plan year unless there is a change in status or other qualifying event that permits a midyear election change. Current IRS regulations provide a laundry list of these permitted events, including life events (e.g., marriage, divorce, birth of a child), employment status changes (e.g., full-time to part-time), employer-initiated changes to coverage (e.g., midyear increase in employees' premiums), and enrollment opportunities under another employer plan with a different plan year.

Under these current IRS rules, in order for life events and employment status changes to justify a midyear modification to the employee’s coverage election, the change in status must affect the employee’s eligibility for coverage. For example, an employee whose work hours are reduced from 40 to 20 hours per week may not drop health coverage if he or she remains eligible for coverage under the employer’s health plan.

Lockton Comment: This can create great difficulty for the employee, as the cost of the coverage might create a financial hardship. Equally disappointing is that the employee might otherwise have been able to qualify for heavily subsidized individual coverage through a public health insurance exchange, but is disqualified due to the existing employment-based coverage; an employee enrolled in any employer-based health plan is disqualified from subsidies in an insurance exchange.

This problem would arise with frequency in the post-ACA world, where an employer is required to treat an employee as full-time through a 12-month stability period based on average hours per week during the preceding measurement period, but during that stability period the employer reduces the employee’s hours. To avoid potential penalties the employer must continue to treat the employee as eligible for coverage, but the employee might have trouble paying for it.

Generally, where a modification in the coverage election is permitted, any modification the employee makes must be consistent with the change in status. For example, if an employee gains a dependent during the plan year, the employee may add coverage for the dependent, but generally is not permitted to drop coverage, as that would not be consistent with the arrival of the new dependent.

Lockton Comment: This restriction, too, can cause hardship in the post-ACA world. Covered employees who gain a dependent might prefer to enroll the family in exchange-based coverage. The rules governing the public insurance exchanges permit midyear special enrollments (that is, enrollments outside of the exchanges’ annual enrollment period) due to gaining a dependent. But existing IRS rules don’t permit the employee to drop the employer’s pretax coverage in order to move to a public exchange.

Finally, existing IRS rules allow an employer to permit an employee to drop the employer’s pretax coverage midyear, and gain coverage under another employer plan with a different plan year. For example, an employee covered under a calendar year plan might wish to drop coverage midyear and enroll under his or her spouse’s plan, which has a July 1-June 30 plan year, during that plan’s open enrollment period.

Unfortunately, this “dueling plan year” rule currently does not permit an employer to allow an employee to drop coverage midyear in order to leap to a public insurance exchange during the
exchange's open enrollment period, which for 2015 runs from Nov. 15, 2014, to Feb. 15, 2015. This would only be an issue, of course, for employers with non-calendar year cafeteria plans; calendar year plans would have open enrollments beginning roughly the same time as the exchange's open enrollment period.

**IRS's New Proposal Would Remedy These Problems**

*Employee’s Hours Are Reduced*

With respect to situations where an employee’s hours are reduced during a stability period, the newly proposed rule would allow employers to permit the employee to drop employer coverage where the employee intends to procure exchange-based coverage.

To qualify for this relief, the employee’s hours must be reduced so that he or she is reasonably expected to average fewer than 30 hours per week prospectively, and the employee must intend to obtain exchange-based coverage (or any other employment-based coverage considered "minimum essential coverage") by the first day of the second month following the date the employee drops his or her current plan.

The employer may allow the employee to drop coverage where the employee simply intends to obtain other coverage; the employer need not insist that the employee actually enroll in the other coverage, as a condition of dropping the employer plan. The employer may accept the employee’s representation about what the employee intends to do.

**Lockton comment:** Note that this new rule would apply only when an employee’s hours are reduced; it would not apply to an employee pay cut without an accompanying reduction in hours. Note also that the IRS requires that the employee be expected to average fewer than 30 hours per week. Here the IRS appears to mean the employee is expected to average fewer than 30 hours per week going forward, and not necessarily for the measurement period during which the reduction in hours occurs.

*Life Events and Exchange Open Enrollment Period*

With respect to the addition of new dependents (e.g., the employee has a baby or gets married, and wants to drop employer coverage and move to a public health insurance exchange), or where the employee is enrolled under a non-calendar year employer plan and wants to leap to a public health insurance exchange during the exchange’s open enrollment period, the proposed rule would allow employers to permit the employee to drop coverage and move to the exchange.

Specifically the proposed rule would permit the employer to allow the employee to drop the employer’s coverage midyear, where the employee expresses intent to leap to a public health insurance exchange (1) during the exchange’s open enrollment period, or (2) due to an event considered an exchange “special enrollment event.” These special enrollment events include: gaining a dependent through marriage, birth, adoption, placement for adoption, or placement in foster care; becoming a U.S. citizen, national or lawfully present alien; and gaining access to new exchange-based coverage due to a permanent move.
Interestingly, and unlike the situation where the employee drops coverage due to a reduction in hours, the IRS wants the transition to an exchange-based policy to occur without any gap in coverage. That is, the exchange-based coverage is supposed to start the day after the last day of the existing coverage that the employee revokes. But here, too, the proposed rule would allow the employer to rely on the employee’s reasonable representation that he or she will enroll in the new coverage. In other words, proof that the employee actually enrolled in the exchange is not required.

**Lockton Comment:** The new rules also appear to allow employees to drop the employer’s dental and vision coverage, *but not health FSA coverage*, when they move to the exchange.

The ability of employees to move from an employer’s plan in these several instances will raise the possibility of adverse selection against exchange-based plans. For example, employers will have the option of allowing an employee with premature triplets to retain employer coverage or drop that coverage and move to an exchange coincident with the birth of the children.

For their part, employers may develop an itch to offer a financial incentive for employees to disenroll in the employer plan in situations like this, but should carefully consider the legal and practical issues in doing so. Although the ACA does not contain an anti-dumping rule with respect to exchange-based coverage, other federal law contains a number of employment nondiscrimination rules implicated here.

**Action Steps**

The new rules apply on Sept. 18, 2014. Although only proposed, employers may rely on them until further notice from the IRS. Employers who want to apply the new rules after Sept. 18, 2014, must amend their Section 125 plans before the end of the 2015 plan year, communicate the change, and operate their plans in accordance with the new rules.

Employers who want to use the new rules in 2015 may need to scramble to explain the new rules during the upcoming open enrollment, but also have until the end of 2015 to amend their Section 125 plans.

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