IRS softens cafeteria plan midyear change rules due to the COVID-19 outbreak, but will leave FSA enrollees unsatisfied

The question Lockton Compliance Services has fielded more than any other since the coronavirus forced closures of schools, businesses and other establishments is, "Due to the issues raised by the coronavirus, can our employees add coverage, drop coverage or decrease flexible spending account (FSA) elections midyear, under our Section 125 cafeteria plan?"

Yesterday the IRS offered new guidance giving employers more temporary flexibility to allow changes to employees’ coverage elections under a cafeteria plan, and more time to incur FSA claims, but did not address the one question to which employees most wanted an answer: “Can I please get a refund of my FSA contributions?”

What’s new?

The general rules for Section 125 cafeteria plans prohibit midyear changes to pretax insurance coverage elections, except under limited circumstances set out in IRS regulations. Responding to a pandemic is not one of those circumstances. To reduce the hardship of those rules under the current circumstances, the IRS has loosened those restriction by permitting, but not requiring, employers to amend their cafeteria plans to allow employees to make one, some or all of the following midyear, prospective coverage changes for calendar year 2020:

**Leap into the employer’s plan.** Employers may allow employees to opt into the employer’s healthcare plan, if the employee had earlier (i.e., at open enrollment for the current plan year or at initial enrollment earlier in the current plan year) declined coverage.

**Lockton comment:** As the coronavirus first began posing an imminent public health threat in the U.S., some medical insurance carriers announced they would open their group plans’ doors midyear to allow enrollment by employees who had earlier declined coverage. We noted at the time that the cafeteria plan rules would not permit this change on a pretax basis and wondered why employers
would want to allow this, but we also expressed a belief that it seemed unlikely the IRS would enforce their prohibition on such changes.

In this we were prescient. Today’s IRS guidance allows the employer to amend its cafeteria plan retroactively to validate these changes that the employer may have already permitted.

**Change coverage under the employer’s plan.** Employers may allow employees to revoke an existing coverage election and make a new prospective election for different coverage offered by the employer (including coverage under a different tier, such as a switch from self-only to family coverage, or a move from an HMO plan to a PPO plan, for example).

**Drop coverage and leap to other coverage elsewhere.** Employers may allow employees to revoke an existing coverage election without making a new prospective election for other coverage under the employer’s healthcare program, as long as the employee attests that the employee is enrolled in – or will immediately enroll in – other “comprehensive coverage” elsewhere (such as the plan of a spouse’s employer).

**Lockton comment:** The IRS expects the employer to obtain an attestation from the employee regarding the coverage or imminent enrollment under another employer’s healthcare coverage. The IRS includes sample attestation language. It appears at the end of this alert.

**Make FSA changes.** Employers may allow employees to revoke a health and/or dependent care FSA election entirely, make a new prospective FSA election for coverage, or increase or decrease an FSA coverage election. For employees looking to decrease FSA elections, employers are permitted to grant the request only to the extent of amounts not already reimbursed. For example, say the employee elected a $1,200 annual FSA benefit, has received $400 in reimbursements to this point in the year, and wants to reduce the FSA coverage election. The employer may permit the employee to reduce the annual election to $400 but is not required to permit the employee to choose a lower annual amount, which would trigger a net loss for the employer.

The IRS failed to respond to the issue employees nearly everywhere wanted addressed: Can I get a refund of my FSA balances because I’m unlikely now to incur the health and dependent care expenses I thought I would, when the year began? The IRS relief does not extend that far, at least not yet. In addition, the guidance specifically notes that the healthcare and dependent care FSAs may only be used for their stated purposes. That means that employees cannot swap funds from one FSA to the other.

An employer willing to allow these midyear election changes is permitted to limit them in any way the employer deems advisable, provided the limits do not violate the cafeteria plan nondiscrimination rules prohibiting discrimination in favor of highly compensated individuals.

**Lockton comment:** Dependent care FSAs sometimes do inadvertently discriminate in favor of highly compensated individuals, requiring a reduction of the amounts available for such individuals. It is possible that as nonhighly compensated employees reduce dependent care FSA elections the risk of impermissible discrimination in favor of highly compensated employees could grow. Employers might want to run a nondiscrimination analysis now, rather than waiting until year end, to determine whether dependent care FSA benefits for the highly compensated should be unilaterally reduced to avoid a discrimination issue. Other than dependent care FSAs, cafeteria plans rarely raise nondiscrimination concerns.

The guidance specifically notes that employers may want to limit the changes they allow, to prevent adverse selection in their plans (for example, not allow an employee to leap from self-only to family coverage without some other qualifying reason, like loss of coverage under a spouse’s plan).
Extended grace and claim filing periods

Under current rules, health and dependent care FSAs may allow a two-and-a-half-month grace period after the close of a plan year. Employees with residual and otherwise forfeitable dollars in their FSA accounts may use the grace period to incur additional claims to apply against those residual dollars, to avoid forfeiting those dollars. Alternatively, health FSAs (but not dependent care FSAs) may provide for “carryovers,” permitting employees to carry over into the entire next health FSA plan year up to $500 in residual dollars from the prior FSA year.

**Lockton comment:** In separate guidance issued yesterday, the IRS said it is adjusting the $500 carryover amount for inflation, starting with carryovers for plan years beginning in 2020. The maximum carryover from a 2020 plan year into the 2021 plan year is $550. Employers wishing to adopt an inflation-adjusted carryover limit may need to amend their health FSAs to provide for it, if the FSA’s current language specifically limits the carryover amount to $500.

To address employees’ inability to obtain care during the coronavirus pandemic and its related shelter-in-place orders, the IRS is permitting (but not requiring) employers to extend any grace period ending in 2020 (i.e., a grace period for a plan year beginning in 2019) to Dec. 31, 2020.

Employers with health FSAs that allow for carryovers may similarly extend until Dec. 31, 2020, the period allowed for incurring claims for the plan year beginning in 2019, thus deferring until the end of 2020 the date as of which the employee’s residual carryover amount will be determined for the balance of the new plan year.

**Lockton comment:** This accommodation for carryover amounts applies only to non-calendar year health FSAs with a plan year beginning in 2019. When that plan year ends in 2020 (such as June 30, 2020) the employer may allow the employee to continue to incur claims until Dec. 31, 2020, and pay those claims from residual dollars in the FSA on June 30, 2020. In this way, the employee’s carryover amount for the 2020-21 plan year isn’t determined on July 1, 2020, but rather on Jan. 1, 2021.

The guidance permits this flexibility with respect to FSA grace and carryover periods for FSAs that already have grace periods or allow carryovers. It is unclear whether the guidance can extend to FSAs that do not already provide those features, were the employer to add them now.

The usual grace period trap gets larger

Some employers need to be cautious in adopting these changes. There is a trap for the unwary here, for employers contemplating a transition to health savings account (HSA)-compatible coverage later this year. Where the employer allows for the extended grace period described above, the health FSA’s coverage for the plan year beginning in 2019 will be deemed to continue through the end of the extended grace period (in our example, to Dec. 31, 2020). If the FSA is not an HSA-compatible, limited-purpose FSA, the employees who enroll later this year in the new HSA-compatible medical coverage will be ineligible to make HSA contributions until at least the first month following the end of the extended grace period (in our example, until January 2021).
Plan amendments and retroactivity

The special accommodations for midyear coverage election changes may be allowed only up to the end of the 2020 calendar year. An employer wishing to allow these changes should amend its cafeteria plan to provide for them. The amendment should be adopted by Dec. 31, 2021, reflect the extent of any retroactive application, and may not apply to midyear election changes made after that date.

Speaking of retroactivity, the IRS will allow the employer to install the amendment with a retroactive effective date to essentially bless, after the fact, any of these changes the employer has already allowed in 2020. However, new election changes made in accordance with yesterday’s guidance may only be given prospective effect, that is, the new pre-tax salary reduction election can apply only to future salary. But in an interesting twist the IRS says that if an employee now opts into the employer’s FSA pursuant to yesterday’s guidance, while the benefit amount elected by the employee can only be funded from future salary, the FSA may reimburse claims incurred earlier in the year, before the employee enrolled in the FSA.

Changes to FSA grace periods or carryover provisions should also be adopted by plan amendment.

Relationship to recent guidance extending various plan-related deadlines

There is little relationship between today’s guidance and the recent guidance from the IRS and Department of Labor mandating that welfare benefits plans toll the running of certain coverage election, notice, claim submission, appeal and premium payment deadlines. Today’s guidance is permissive; employers may choose to provide these changes but are not required to do so. Employers must comply with the recent guidance relating to tolling of certain deadlines.

Conclusion

The IRS has been issuing guidance at an accelerated rate during the current pandemic. As noted above, these changes do permit some level of flexibility. However, many employees may not see these changes as particularly meaningful, and some of the changes would introduce some additional risk for employers. Therefore, their adoption should be studied before taking the leap.

Model attestation

The IRS offered the following language as acceptable attestation language when an employee seeks to withdraw from the employer's healthcare plan midyear and leap to other comprehensive healthcare coverage elsewhere:

Name: _______________________ (and other identifying information requested by the employer for administrative purposes)

I attest that I am enrolled in, or immediately will enroll in, one of the following types of coverage: (1) employer-sponsored health coverage through the employer of my spouse or parent; (2) individual health insurance coverage enrolled in through the Health Insurance Marketplace (also known as the Health Insurance Exchange); (3) Medicaid; (4) Medicare; (5) TRICARE; (6) Civilian Health and Medical Program of the Department of Veterans Affairs (CHAMPVA); or (7) other coverage that provides
comprehensive health benefits (for example, health insurance purchased directly from an insurance company or health insurance provided through a student health plan).

Signature: ______________________

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