

COVID-19 Update: New Section 125 Cafeteria Plan Relief and Guidance

The Internal Revenue Service ("IRS") recently issued [Notice 2020-29](#) and [Notice 2020-33](#) which allow employers to provide various new types of relief to employees participating in Section 125 cafeteria plans (including flexible spending account arrangements) related to the coronavirus (COVID-19) outbreak, clarify certain eligibility rules around health savings accounts, update the carry over limit for health flexible spending arrangements ("health FSAs"), and provide other clarifications relating to certain health reimbursement arrangements ("HRAs").

Notice 2020-29

In an effort to provide additional relief to employees impacted by the COVID-19 pandemic and the unanticipated changes to health care needs as well as to the availability of health care and dependent care services, the new guidance from the IRS under Notice 2020-29 allows employers to (i) permit mid-year cafeteria plan elections relating to group health coverage, health FSAs and dependent care FSAs in the absence of an employee status change and (ii) temporarily expand the ability for certain employees to utilize any unused amounts in health FSAs and dependent care FSAs that would normally be forfeited at the end of a plan year (or an applicable grace period). Finally, IRS Notice 2020-29 also clarifies that certain coverage under high deductible health plans ("HDHPs") that pay for COVID-19 and similar testing and telehealth benefits will not disqualify an employee from eligibility to make contributions to a health savings account ("HSA") during 2020.

Availability of Mid-Year Elections/Changes

Generally, elections under a cafeteria plan must be made prior to the first day of the plan year and must be irrevocable, except that plans are permitted, but not required, to allow employees to make election changes in limited circumstances, such as if the employee experiences a change in status or where there is a significant change in the cost of coverage.

IRS Notice 2020-29 provides temporary flexibility by allowing (but not requiring) employers to amend their cafeteria plans to permit employees to make prospective mid-year election changes related to employer-sponsored health coverage, health FSAs (including both general purpose and limited purpose health FSAs), and dependent care FSAs during calendar year 2020, whether or not the basis for the election change meets one of the criteria under otherwise applicable regulations. Specifically, a cafeteria plan may allow employees to:

1. make a new election for employer-sponsored health coverage on a prospective basis, if the employee initially declined such coverage;
2. revoke an existing election for employer-sponsored health coverage and make a new election to enroll in different employer-sponsored health coverage on a prospective basis (e.g., changing from self-only coverage to family coverage);
3. revoke an existing election for group health coverage on a prospective basis without a corresponding election to enroll in other health coverage offered by the employer, so long as the employee attests in writing¹ that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer;
4. revoke an election, make a new election, or decrease or increase an existing election with respect to a health FSA on a prospective basis;² and
5. revoke an election, make a new election, or decrease or increase an existing election with respect to a dependent care FSA on a prospective basis.

¹ A model employee attestation is provided in IRS Notice 2020-29.

² While the new election will need to apply prospectively to salary reductions toward the health FSA, we understand that the increased elected amount is permitted (if so provided in the plan amendment) to be used toward eligible medical expenses incurred during the entire plan year commencing in 2020 (and, if applicable, the related grace period).

Employers that choose to permit such mid-year election changes may (but are not required to) allow employees to make multiple mid-year election changes in 2020, so long as each election change is applied on a prospective basis only. The permitted mid-year election changes could have been made on or after January 1, 2020 (to address any cafeteria plans that permitted mid-year election changes consistent with IRS Notice 2020-29 prior to its issuance). This relief is available whether an employer-sponsored health plan is self-insured or fully-insured.³

The IRS has acknowledged that this relief creates the possibility of adverse selection of health coverage by employees, and notes that employers may limit mid-year election changes to situations where an employee's health coverage will be increased or improved (e.g., from self-only to family coverage, or from a lower tier plan to a higher tier plan). In addition, for health FSAs and dependent care FSAs, employers are also allowed to limit mid-year elections to amounts no less than amounts already reimbursed. As noted above, employers are not required to allow any of these newly permitted election changes, as their implementation by employers is voluntary.⁴

2020 FSA Liberalization

Generally, a health or dependent care FSA plan must incorporate a "use-or-lose" rule under which unused benefits or contributions to the FSA remaining as of the end of a plan year ("unused amounts") are forfeited (subject to a "run-out" period immediately following the end of a plan year where participants may submit documentation to request reimbursement of expenses incurred during the plan year). Under existing IRS guidance,⁵ there are two exceptions to this "use-or-lose" rule that cafeteria plans are permitted (but not required) to adopt: (i) a grace period rule (for health or dependent care FSAs) that allows unused amounts to be available to pay for qualifying expenses incurred during the period of up to two months and 15 days following the end of that plan year or (ii) a carryover rule (for health FSAs only) described in more detail below under the heading Notice 2020-33. A cafeteria plan may adopt either one of these exceptions (as applicable) to the "use-or-lose" rule (but not both of them), for any one type of FSA.

For cafeteria plans that utilize either the grace period rule (for health and/or dependent care FSAs) or the carryover rule (for health FSAs only), IRS Notice 2020-29 allows (but does not require) an employer to amend a cafeteria plan to provide an extended period to apply unused amounts remaining in a health FSA account or dependent care FSA account as of the end of a **grace period ending in 2020**, or as of the end of a **plan year ending in 2020**, to pay for or reimburse qualifying expenses incurred through December 31, 2020.⁶ Effectively, (i) for plans that use the grace period rule, this can extend the grace period to the end of 2020 and (ii) for *non-calendar year* plans, whether or not they utilize a grace period or carryover rule, can provide what is essentially a grace period that lasts until the end of 2020.⁷

We note that this relief allowing the extension of the period to incur new claims is separate from the prior relief provided by the IRS to extend the period to submit reimbursement claims for previously incurred expenses during the COVID-19 pandemic outbreak period (which is described in more detail in our prior alert, available [here](#)).

The relief can be illustrated by the following examples:

Example 1: A cafeteria plan (with a plan year that is a calendar year) that has a grace period ending on March 15, 2020 with respect to unused amounts in a dependent care FSA from the 2019 plan year (which would normally allow those unused amounts to be used to reimburse any qualifying expenses incurred through March 15, 2020) is permitted to be amended to allow employees to use any unused amounts from the 2019 plan year to also reimburse the employee for dependent care expenses incurred during the period from March 16, 2020 to December 31, 2020.

Example 2: A cafeteria plan (with a plan year from July 1 to June 30) that permits a \$500 carryover from the prior (2019-2020) plan year for a health FSA is permitted to be amended to allow an extended period (i.e., until December 31, 2020) to incur additional eligible medical expenses and claim reimbursement from the 2019-2020 health FSA account (outside of the carryover exception). Thus, if Employee X has a remaining balance of \$2,000 on June 30, 2020 (rather than only being allowed to carry over \$500 into the 2020-2021 plan year and forfeiting \$1,500 with respect to possible reimbursements for expenses incurred on

³ The applicability of the mid-year change in election rules to employees who are enrolled only in stand-alone dental or vision coverage is not entirely clear.

⁴ Please note that if FSA election changes are permitted and employees make changes to their elections, there could be an impact on applicable non-discrimination testing for 2020 (in particular for dependent care FSAs).

⁵ See IRS Notice 2005-42 for the grace period rule and IRS Notice 2013-71 for the carryover rule.

⁶ However, note that it is still the rule that (i) health FSA unused amounts can only be used for eligible medical expenses and (ii) dependent care FSA unused amounts can only be used for eligible dependent care expenses.

⁷ We further note that for a non-calendar year cafeteria plan that adopted the carryover rule for an FSA, the relief (if implemented) would effectively be adding a feature similar to a grace period. Notice 2020-29 permits this notwithstanding the normal rule that a cafeteria plan cannot have both a grace period and a carryover for any one type of FSA.

or prior to on June 30, 2020, which is the end of the 2019-2020 plan year), Employee X can now be permitted to use the unused amount from the 2019-2020 plan year to pay for eligible medical expenses incurred between July 1, 2020 and December 31, 2020.

- If Employee X incurs eligible medical expenses of \$1,900 in November 2020, Employee X can be reimbursed for that amount from the 2019-2020 health FSA account, and then carryover the remaining \$100 from the 2019-2020 plan year into the 2020-2021 plan year.

- However, if Employee X incurs only \$900 in additional eligible medical expenses prior to December 31, 2020, Employee X can receive a \$900 reimbursement from the 2019-2020 health FSA account, but \$1,100 remains in the 2019-2020 health FSA as of December 31, 2020. Employee X may only carryover \$500 into the 2020-2021 plan year and will forfeit \$600.

Employers who choose to implement this relief to extend the period to incur expenses under a health FSA should proceed with caution, as the IRS notes that such extension (e.g., of a general purpose health FSA) could cause an employee to not be eligible to contribute to an HSA during the extension period (unless the health FSA were HSA-compatible). The IRS guidance suggests (but is not clear) that an employer might be able to limit this extension of the health FSA only to HSA-compatible coverage (for example, by limiting its availability to only dental, vision, and preventive care expenses) to avoid inadvertently disqualifying employees from the ability to contribute to HSAs.

Plan Amendments

If an employer wishes to take advantage of the relief provided with respect to the mid-year election change or other health and dependent care FSA changes available in 2020 under IRS Notice 2020-29 (which, again, are optional and not required), the employer must amend the plan document on or before December 31, 2021. The amendment may be effective retroactively to January 1, 2020, so long as the employer informs all individuals eligible to participate in the cafeteria plan of the changes to the plan.

Clarifications relating to HSA Eligibility

Generally, an employee is eligible to establish and contribute to an HSA if, with respect to any month, that employee (i) is covered under an HDHP as of the first day of that month and (ii) does not have any other disqualifying health coverage (e.g., other health coverage, such as a general purpose health FSA, or another non-HDHP health plan that provides coverage for any benefit which is covered under the HDHP but before the applicable deductible under the HDHP is met).

As described in our prior alert (available [here](#)), (i) under IRS Notice 2020-15, the IRS provided an exception to the general HSA eligibility rules by allowing HDHPs to cover medical care services and items purchased related to testing for and treatment of COVID-19 prior to the satisfaction of the applicable deductible under the HDHP and (ii) the Coronavirus Aid, Relief, and Economic Security ("CARES Act")⁸ amended the statutory rules relating to HSA eligibility to allow HDHPs to cover telehealth and other remote care services without a deductible during plans years beginning on or before December 31, 2021, in each instance, without disqualifying an employee from HSA eligibility.

The new IRS Notice 2020-29 (i) clarifies that the exception under the prior IRS Notice 2020-15 for testing and treatment also extends to diagnostic testing for influenza A & B, norovirus and other coronaviruses, and respiratory syncytial virus (RSV) and any items or services required to be covered with zero cost sharing pursuant to Section 6001 of the Families First Coronavirus Response Act⁹ (as amended by the CARES Act) and (ii) clarifies that the exception for telehealth and other remote care services under the CARES Act (even though as a technical matter the statutory changes were effective as of March 27, 2020) applies with respect to services provided on or after January 1, 2020 with respect to plan years beginning on or before December 31, 2021. Accordingly, employees who receive coverage for these types of services or treatments will not be disqualified from HSA eligibility solely because of receiving the type of coverage described in these exceptions.

⁸ Section 3701 of the CARES Act amended Section 223(c) of the Internal Revenue Code (the "Code").

⁹ Generally, Section 6001 of the Families First Coronavirus Response Act mandates that a group health plan and a health insurance issuer will provide coverage, without imposing any cost sharing (e.g., deductibles, copayments, and coinsurance) for certain diagnostic testing relating to COVID-19.

Notice 2020-33

Increase to Health FSA Carryover Limit

As noted above, generally, a health FSA must incorporate a "use-or-lose" rule under which unused amounts are forfeited (subject to a run-out period for submitting claims), except that there are two exceptions to the "use-or-lose" rule allowed in a cafeteria plan: (i) a grace period rule (described above) or (ii) a carryover rule (for health FSAs only) allowing up to \$500 of unused amounts to be carried forward and added to the health FSA account balance for the next plan year (without this carryover amount counting toward the annual indexed limit for that next plan year (\$2,750 for 2020)). A cafeteria plan may adopt either one of these exceptions (as applicable) to the "use-or-lose" rule (but not both of them), for any one type of FSA.

IRS Notice 2020-33 modifies the carryover rule for health FSAs to increase the maximum unused amount that may be carried forward from \$500 to 20% of the current indexed health FSA pre-tax elective contribution limit for the year from which amounts can be carried forward. That will increase the maximum permitted carryover amount to \$550 for carry forwards from plan years beginning in 2020 to plan years beginning in 2021 (20% of \$2,750)¹⁰. The increased carryover limit is an optional change that may (but is not required to) be adopted by employers. If an employer chooses to amend its cafeteria plan to increase the carryover limit as so permitted, even for carryovers from the 2020 plan year to the 2021 plan year, the amendment may be adopted anytime on or before the last day of the plan year that begins in 2021 (so for a calendar year plan, any time before December 31, 2021), so long as participants are notified of the change.

Guidance on Individual Coverage HRAs

In 2019, the Departments of Treasury, Labor, and Health and Human Services issued final regulations that permitted employers to establish two new types of HRAs, including "individual coverage HRAs." For a more detailed discussion of the new types of HRA under those final regulations, please refer to our prior client alert (available [here](#)). Under existing tax rules applicable to employer sponsored health plans under Code Sections 105 and 106, individual coverage HRAs generally can only reimburse employees on a tax-free basis for eligible medical expenses incurred by an employee during the plan year.

Adopting a similar rule of administrative convenience that has previously been provided to qualified small employer HRAs (QSEHRAs),¹¹ IRS Notice 2020-33 provides an exception to the general rule that an individual coverage HRA may not reimburse medical care expenses incurred before the beginning of the plan year, by treating an expense for a premium for health insurance coverage as incurred on (1) the first day of each month of coverage on a pro rata basis, (2) the first day of the period of coverage, or (3) the date the premium is paid.

As a result, an individual coverage HRA (that has a calendar year plan year) will be allowed to immediately reimburse premiums for health insurance coverage that begins on January 1 of that plan year, even if the participant paid the premium for the coverage in December of the prior plan year (i.e., prior to the first day of the plan year).

¹⁰ Note that the \$500 limit on amounts that can be carried forward from a plan year beginning in 2019 to a plan year beginning in 2020 is not changed.

¹¹ See Notice 2017-67, Q&A-52 for the exception that allows for QSEHRAs to treat a premium expense for a period of coverage as incurred on (1) the first day of each month of coverage on a pro rata basis, (2) the first day of the period of coverage, or (3) the date the premium is paid.

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