



# New IRS Guidance Provides Employers with Section 125 Plan Flexibility During 2020

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## Introduction

On May 12, 2020, the Internal Revenue Service (IRS) issued two new notices ([Notice 2020-29](#) and [Notice 2020-33](#)) addressing some of the many Section 125 Cafeteria Plan questions and issues raised by plan sponsors, administrators, and participants as a result of the COVID-19 pandemic.

These notices provide plan sponsors opportunities to adopt certain participant-friendly plan measures, including: (i) allowing participants to make certain prospective mid-year health coverage and flexible spending account (FSA) election changes, (ii) expanding grace periods for dependent care FSAs, and (iii) expanding grace periods and carryovers for health care FSAs. The IRS guidance under these notices is *completely discretionary*—and plan sponsors may choose whether to incorporate some, all, or none of the new measures permitted by the IRS. Plan sponsors wishing to incorporate any such measures must do so via plan amendment adopted no later than December 31, 2021 (and may apply such changes to be retroactively effective as of January 1, 2020).

- *Note:* Except for the permanent increase to health care FSA carryover limits under Notice 2020-33, all other Section 125 Cafeteria Plan guidance described in the notices applies temporarily through December 31, 2020.

## IRS Permits New Mid-Year Election Changes to Health Coverage and FSAs

Generally, Section 125 of the Internal Revenue Code, as amended (the Code) requires participant benefit elections under a Cafeteria Plan to be made prior to the beginning of the plan year and such elections are treated as irrevocable during such period. Code Section 125, however, permits certain exceptions to this irrevocability rule—thereby permitting mid-year adjustments to benefit elections as a result of certain life events affecting participants and their dependents (e.g., changes in the number of dependents, changes to coverage options, loss of coverage provided by a spouse's employer, etc.).

The COVID-19 pandemic has affected participants' life circumstances and benefit needs in many ways which, until now, have not been specifically addressed in the existing IRS guidance on mid-year election changes. Thus, the intention of the notices is to address this lack of guidance, and to specifically accommodate participant election changes regardless of whether the basis for the election change satisfies the previously existing IRS criteria set forth in Treas. Reg. § 1.125-4 and make other conforming changes.

## **1. Permitted Mid-Year Election Changes to Participant Health Coverage.**

For the remainder of the 2020 plan year, sponsors may amend their Cafeteria Plans to allow eligible employees and active participants to **prospectively** adjust health plan coverage elections as follows:

- Permit eligible employees who originally declined coverage (either during open enrollment or other mid-year election windows) to make new enrollments (which include enrolling in coverage, dropping coverage, or enrolling in a different coverage option under an employer's group health coverage).
- Permit participants to modify existing elections and coverage levels, and enroll new dependents under health coverage sponsored by the same employer.
- Permit participants to completely revoke existing elections in favor of health coverage not sponsored by the employer.
  - Before approving a mid-year revocation of a participant's health coverage election, plan sponsors must obtain written attestation that the participant is covered (or will be covered immediately afterwards) by coverage sponsored by another employer or exchange coverage. Notice 2020-29 contains template participant attestation language plan sponsors may utilize for this purpose.

***Winston Takeaway: This IRS guidance refers to health plans, but the examples mention only medical coverage and FSAs. Reference to other qualified Cafeteria Plan benefits (such as vision and dental) is notably absent. Further clarifying guidance from the IRS is welcomed. Moreover, the IRS guidance addresses mid-year election changes only from the perspective of compliance with the Cafeteria Plan rules. While the guidance is favorable to plan participants, employers with fully-insured coverage or stop loss coverage will need to confirm that mid-year election changes will be permitted under the terms of the insurance policy before making any changes in response to these notices. Insurers may be opposed to mid-year election changes on the basis of adverse selection and underwriting concerns. In addition, employers with self-insured coverage should check with their third party administrators (TPAs) before offering such changes to their participants, since fluctuations in enrollments may result in additional administrative fees.***

## **2. Permitted Mid-Year Election Changes to Participant FSAs.**

For the remainder of the 2020 plan year, plan sponsors may amend their Cafeteria Plans to allow eligible employees and active participants to **prospectively** adjust health care FSA (including limited scope) and dependent care FSA elections as follows:

- Permit eligible employees who originally declined enrollment (either during open enrollment or other mid-year election windows) to make new enrollments.
- Permit participants to increase or decrease payroll contribution amounts to existing FSAs.
- Permit participants to completely revoke their existing FSA enrollments.

***Winston Takeaway: Plan sponsors should discuss desired changes with TPAs to ensure smooth implementation and communication to participants. Since the entire health FSA election amount is available on the first day of the plan year (regardless of the current health FSA account balance), allowing participants to reduce their health FSA and limited-purpose health FSA elections should be examined closely. Thus, in order to avoid potential losses from overspent accounts, plan sponsors should consider limiting the extent of a participant's mid-year FSA contribution decreases (or complete revocations) to amounts no less than amounts already reimbursed to participants during the plan year.***

# IRS Expands Opportunities to Avoid Forfeiture of Unused FSA Funds

Under the Cafeteria Plan rules, amounts held in participant health and/or dependent care FSAs must generally be used or forfeited by the end of the plan year in which the funds were contributed. The IRS does, however, recognize two exceptions to the use-it-or-lose-it rule: (i) for health care FSAs *only*, a plan may permit a carryover of up to \$500 in unused funds to the next plan year, and (ii) for health care (including limited-purpose) and dependent care FSAs, a plan may permit a grace period (through no later than March 15 of the following plan year) when participants may apply any unused funds from the prior plan year toward qualifying expenses incurred during the grace period in the next plan year. IRS rules dictate that Cafeteria Plans may offer either, but not both, of these options.

The COVID-19 pandemic has affected the availability of, demand for, and usage of many qualifying FSA expenses and services. Amounts held in participant health and/or dependent care FSAs not used by the end of the grace period will be forfeited. Whereas amounts in excess of the carryover amount in a participant's health FSA will be forfeited. The notice acknowledges that participants may have an increase or decrease in medical expenses, or a decrease in the need for dependent care assistance due to the unanticipated closure of schools and child care providers and changes to the employee's work location or schedule. The IRS guidance provides participants with additional opportunities to exhaust FSA funds and limit potential forfeitures in light of these unforeseen circumstances.

## Increased Health Care FSA Carryover Limit

In response to a 2019 Presidential Executive Order directing the IRS to review FSA carryover limits, IRS Notice 2020-33 increases the maximum health care FSA carryover amount to \$550 (as periodically adjusted for inflation). Going forward as part of this new guidance, the permitted carryover will be indexed to reflect an amount equal to 20% of the maximum permitted health FSA contribution for that plan year.

***Winston Takeaway: Plans with language permitting periodic changes to health care FSA carryover limits (e.g., "as determined annually or otherwise by the IRS") do not require a plan amendment to take advantage of this guidance. For plans without such language (i.e., language referencing the flat \$500 carryover amount), however, plan sponsors must either increase the referenced dollar amount or consider omitting references to specific dollar amounts so as to avoid having to amend the plan each time the IRS revises the maximum carryover amount. Plan sponsors intending to permit the increased carryover amount for 2020 plan year funds must amend their plan by December 31, 2020.***

### 1. Extended Claim Periods for Health Care and Dependent Care FSAs.

Notice 2020-29 provides that through the end of the 2020 calendar year, plan sponsors may amend their Cafeteria Plans to extend the deadline to submit eligible health (including limited purpose) or dependent care FSA claims incurred while a participant was covered by the plan, and before December 31, 2020.

### 2. Extended Grace Periods for Health Care and Dependent Care FSAs.

Notice 2020-29 also provides that through the end of the 2020 calendar year, plan sponsors may amend their Cafeteria Plans to extend grace periods for unused health care (including limited purpose) and dependent care FSA funds.

***Winston Takeaway: Plan sponsors may adopt this extended period for participants to incur and be reimbursed for qualifying expenses only if the underlying plan already includes a grace period feature. Unfortunately, the guidance does not permit employees to get refunds for amounts they have already contributed to a health or dependent care FSA for 2020, and for which they will not have claims to submit for reimbursement.***

# Extended Grace Periods and Health Savings Accounts

Extending the period of time in which a participant may incur claims in a health FSA (except in a limited-purpose health FSA) is an extension of coverage by a health plan that is not a high deductible health plan (HDHP) for purposes of determining whether an eligible individual qualifies to make or receive tax-qualified contributions to a health savings account (HSA). Thus, extending the grace period in a health FSA will possibly disqualify individuals from being able to make or receive tax-qualified contributions to an HSA during the extension period.

***Winston Takeaway: Plan sponsors may want to weigh the benefits of extending the grace period in a general-purpose health FSA against HSA eligibility.***

Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group or your Winston relationship attorney for further information.

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