May 14, 2020

IRS Announces COVID-19 Relief for Cafeteria Plans

On May 12, the IRS released two Notices modifying rules applicable to employee elections under cafeteria plans. As described in more detail in this alert, the new guidance permits midyear cafeteria plan election changes during 2020 and permanently increases the maximum amount that may be carried over from one year to the next under a health flexible spending account (FSA).

Cafeteria plan midyear election changes during calendar year 2020

Cafeteria plans allow employees to choose among two or more benefits consisting of cash and qualified benefits, including employer-sponsored group health plans, dependent care assistance programs (DCAPs) and FSAs. Generally, participant elections under a cafeteria plan must be made prior to the beginning of the plan year and must be irrevocable. Applicable Treasury Regulations provide that a cafeteria plan may (but is not required to) permit midyear election changes in certain circumstances. However, as noted by the IRS in Notice 2020-29, these limited exceptions "may not apply with respect to election changes that employees may wish to request...for reasons related to the COVID-19 public health emergency." In order to assist with the nation's response to the COVID-19 pandemic, Notice 2020-29 provides increased flexibility with respect to midyear election changes under group health plans, FSAs and DCAPs under the following circumstances:

- **Group health plans.** To enable employers to allow employees to make midyear election changes during 2020, Notice 2020-29 provides that a cafeteria plan may be amended to permit employees to:
    - make a new election for employer-sponsored health coverage on a prospective basis if the employee initially declined coverage;
    - revoke an existing election and make a new election to enroll in a different level of coverage (e.g., self-only to family coverage) or different health coverage option (e.g., HMO to PPO) on a prospective basis; and
    - revoke an existing election on a prospective basis (provided that the employee attests in writing that the employee is enrolled, or will immediately enroll, in other health coverage).
    - **FSAs.** Because "some employees may have an increase or decrease in medical expenses due to unanticipated changes in the need for or availability of medical care," Notice 2020-29 provides that a cafeteria plan may be amended to permit employees to revoke, make, increase or decrease an FSA election on a prospective basis.
    - **DCAPs.** Similarly, because "some employees have an increase or 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," Notice 2020-29 provides that a cafeteria plan may be amended to permit employees to revoke, make, increase or decrease a DCAP election on a prospective basis.

Importantly, a cafeteria plan is not required to allow these midyear election changes, and a plan need not allow employees to make unlimited election changes. For example, with respect to group health coverage, the Notice provides that an employer could limit election changes to those situations where the employee's coverage will be increased (single to family, HMO to PPO, etc.). With respect to FSAs and DCAPs, an employer may want to restrict midyear election changes to amounts no less than amounts already reimbursed. **Employers should quickly discuss these changes with counsel and/or their service providers.**

Changes to grace period and carryover rules for FSAs and DCAPs

Generally, contributions to a cafeteria plan during one year may not be used to pay for or reimburse a benefit that is provided in a subsequent year. Under limited exceptions to this "use it or lose it" rule, a cafeteria plan may permit participants to either:

- apply unused amounts remaining at the end of a plan year to pay for expenses incurred during the first 2½ months of the immediately following plan year (a grace period); or
- carry over up to $500 of unused FSA amounts remaining at the end of the plan year to pay for medical expenses incurred at any time during the immediately following plan year.

A cafeteria plan is not permitted to provide for both a grace period and a carryover.

Temporary grace period extension. Notice 2020-29 provides that a cafeteria plan may be amended to permit employees to apply unused amounts remaining in an FSA or a DCAP as of the end of the grace period ending in 2020 or a plan year ending in 2020 in order to reimburse expenses incurred through December 31, 2020. For example, a calendar year cafeteria plan with an FSA that provides for a grace period ending on March 15 may be amended to permit employees to apply unused FSA amounts remaining as of March 15, 2020, in order to reimburse expenses incurred through December 31, 2020. This temporary extended grace period can be adopted by plans that provide for a carryover, notwithstanding the general rule that a cafeteria plan may not offer both a grace period and a carryover. **Employers with calendar year plans should immediately discuss this option with their vendors, which will soon be forfeiting unused 2019 FSA amounts.**

Permanent increase to maximum FSA carryover amount. Notice 2020-33 increases the maximum allowable carryover amount from $500 to 20 percent of the maximum salary reduction contribution under Section 125(i) of the Internal Revenue Code of 1986, as amended, for the plan year. For 2020, the maximum salary reduction contribution for an FSA is $2,750. Accordingly, a participant may carry over up to $550 from the plan year starting in 2020 to the plan year starting in 2021. It should be noted that Notice 2020-33 is not a part of the federal government's relief efforts related to the economic consequences of COVID-19. Rather, this guidance is in response to an executive order issued in 2019, which specifically directed the Treasury to increase the amount under an FSA that can be carried over from one year to the next without penalty. As such, the increase to the maximum amount that may be carried over in an FSA is a permanent change. An amendment must be adopted prior to the end of the plan year in order to apply the increased carryover limit for such year (though, as described below, a special rule applies for 2020).

Plan amendments required

Employers that decide to implement any of the changes described above must amend the terms of their cafeteria plans. Pursuant to Notice 2020-29, plan amendments do not need to be adopted until as late as December 31, 2021; however, eligible employees must be advised of any changes immediately.

If you have any questions regarding the above or any other employee benefits matters, please reach out to any of the attorneys in Day Pitney's Employee Benefits and Executive Compensation practice group.

For more Day Pitney alerts and articles related to the impact of COVID-19, as well as information from other reliable sources, please visit our COVID-19 Resource Center.

COVID-19 DISCLAIMER: As you are aware, as a result of the COVID-19 pandemic, things are changing quickly and the effect, enforceability and interpretation of laws may be affected by future events. The material set forth in this document is not an unequivocal statement of law, but instead represents our best interpretation of where things stand as of the date of first publication. We have not attempted to address the potential impacts of all local, state and federal orders that may have been issued in response to the COVID-19 pandemic.

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