
Cafeteria Plan Mid-Year Election Change Rules

...And Other Recent Legislative Changes Impacting Flexible Spending Accounts

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Section 125 Plans – The Big Picture

- A Section 125 Plan is the exclusive means by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis.
- Without a Section 125 Plan – Employees must include in income any amount which they actually or constructively receive
 - Means that, without a Section 125 Plan, an employee's election between taxable income (including cash) and nontaxable benefits results in taxable income to the employee
- With a Section 125 Plan – Employees avoid constructive receipt
 - Allows employees to make a choice between taxable cash income and nontaxable benefits and not be taxed if they elect the nontaxable benefit

Section 125 Plans – Qualified Benefits

- Only qualified benefits can be part of a cafeteria plan, including:
 - Group Health Plan (Medical, Dental, Vision)
 - Health FSA, Dependent Care FSA
 - HSA
 - Group Term Life (\$50k coverage cap without imputing income on the value of the coverage)
 - AD&D
 - Hospital Indemnity/Cancer Insurance
 - Disability (generally either contributions or benefits are taxable depending on whether premiums are paid on a pre-tax or after tax basis)
 - 401(k) Plan (cash flex credits, uncommon)
 - Adoption Assistance (no FICA exemption, uncommon)
 - PTO Buying/Selling (uncommon)

Plan Document – Timing & Content Requirements

Retroactive Adoption, Amendment or Restatement Prohibited

- Cafeteria plans must be evidenced by a written plan document
- The plan document must be signed (adopted) on or before the date that the plan becomes effective
- If an employer implements a cafeteria plan without a written plan document in place the IRS could find that the cafeteria plan is invalid, resulting in all employee health and welfare premiums and FSA pre-tax elections becoming taxable to employees, as well as under withholding by the employer

- The Section 125 regulations provide that the written plan document must include:
 - A specific description of each of the benefits available through the cafeteria plan, including the periods of coverage
 - The plan’s rules governing participation (only employees and former employees may participate; self-employed individuals are not eligible)
 - The procedures governing employees’ elections under the plan, including the period when elections may be made, the periods with respect to which elections are effective, and providing that elections are irrevocable (outside of the permitted election change events)
 - The manner in which employer contributions may be made
 - The maximum amount of elective contributions available
 - The plan year of the cafeteria plan
 - The special rules that apply to FSAs (e.g., “use-it-or-lose-it” rule, uniform coverage for health FSA)
 - A description of the plan’s grace period or carryover period (if any)

- Section 125 Irrevocable Election Requirement
 - The general rule under Section 125 for ongoing employees is that all elections (including an election not to participate) must be:
 - Made prior to the start of the plan year; and
 - Irrevocable for the duration of the plan year (generally, a 12-month period) unless the employee experiences an election change event, that is permitted under the Section 125 rules, as well as under the terms of the plan

- Consequences of failing to follow the irrevocable election requirement
- If an employer's cafeteria plan were to permit employees to make mid-year election changes without experiencing a permitted election change event, the plan would violate the irrevocable election rule
 - The Section 125 rules provide that the IRS could cause the entire cafeteria plan to lose its tax-advantaged status if discovered on audit, resulting in all elections becoming taxable for all employees, as under withholding by the employer

Making and Changing Elections During Open Enrollment

- No mandatory open enrollment timeframe
 - The Section 125 rules do not specify any period during which an employer is required to offer its open enrollment for the next plan year (nor does ERISA or any other applicable law)
 - The only requirement under Section 125 is that the election be made prior to the start of the plan year
 - It is permissible (but not required) to allow employees to make elections all the way up to the last second before the start of the new plan year; however, employers may establish more restrictive open enrollment periods for administrative purposes

Prohibition of Deferred Compensation

- General Rule – A cafeteria plan may not permit employees to defer compensation to a future year
- Results in the “use it or lose it” rule for FSAs (i.e., amounts may generally not be carried forward to future years)
- Exceptions to prohibition of deferred compensation:
 - 401(k) plan deferrals (although permitted, 401(k) plans are rarely included in cafeteria plans in practice)
 - Contributions to HSAs

- Exceptions to prohibition of deferred compensation (cont.)
 - FSA grace period
 - Allows unused healthcare or dependent care FSA dollars to be used for expenses incurred in the first 2 ½ months of the next plan year
 - Health care FSA carryover
 - Allows up to \$550 (in 2020 and indexed annually) to be carried over and use to pay expenses incurred in the next plan year
- Note that a cafeteria plan may have a grace period provision or a carryover provision, but not both

Making/Changing Elections: Mid-Year Election Changes – Annual Rules

- Employers do not have to include all (or any) permitted election change events in a cafeteria plan
- However, most employers allow all of the permitted election change events to assist employee needs
- Most cafeteria plans require employees to request a mid-year election change within 30 days from the date of the permitted election change event
 - Administrative convenience
 - Helps insure “consistency” requirement is satisfied

Making/Changing Elections: Status Change Events

- Status Change Events
 - This is the broadest and most widely used category of permitted election change events
 - Generally requires that the election change be on account of and correspond with the event – commonly referred to as the “consistency rule”

Making/Changing Elections: Status Change Events

- Status changes include:
 - Change in employee's marital status (i.e., marriage, divorce, death of spouse, legal separation, and annulment),
 - Change in the number of dependents (i.e., , birth, adoption, placement for adoption, death),
 - Change in employment status(i.e. termination, commencement, strike/lockout, termination of or return from unpaid leave, change in worksite or change in employment status affecting eligibility),
 - Dependents satisfying or ceasing to satisfy dependent eligibility requirements,
 - Change in residence, and
 - Commencement or termination of adoption proceedings.
- The plan document must include a provision for each of the above events the employer wishes to allow.

Making Changing Elections: Status Change Events

- Consistency Requirement
 - If a change in status event occurs, a plan can only permit employees to make election changes that are consistent with the event.
 - The change in status event must affect eligibility for coverage under the cafeteria plan or a component plan under the cafeteria plan.
 - For example, a change in marital status (marriage or divorce) affects the eligibility of the new (or former) spouse
 - If one type of coverage is lost/gained, then the election change must be limited that type of coverage.
 - If an employee was not previously enrolled and a change in status occurs which would allow the employee to cover a dependent (e.g., birth of a child), this rule allows the employee to enroll in order to enroll the dependents.
 - Other eligible individuals can also be added when a spouse or dependent gains eligibility as a change in status event.

Making/Changing Elections: Significant Cost Changes

- If the cost of a benefit option under a cafeteria plan significantly increases or decreases, a plan may permit a mid-year election change.
- If costs significantly increase, participants may change to a less costly option providing similar coverage or drop coverage if there is not a similar option to switch to.
- If the cost of an option significantly decreases, participants may commence participation in that option even if they had not previously enrolled in any coverage.
- This rule applies to all qualified benefits except Health Care FSAs.

Making/Changing Elections: Significant Curtailment of Coverage

- If the coverage of an option is significantly decreased (e.g., a significant increase in the deductible, copay or out-of-pocket cost sharing provisions), participants may change to a similar option available under the plan.
- The election can be revoked if no other benefit option providing similar coverage is offered.
- This rule applies to all qualified benefits except Health Care FSAs.

- Participants can elect newly offered or significantly improved benefits on a prospective basis whether or not they previously made an election under the cafeteria plan.
- Applies to all qualified benefits except Health Care FSAs.

Making/Changing Elections: Change in Another Employer's Coverage

- Occurs when another employer's plan covering a spouse or dependent of the employee allows an election change consistent with the regulations or has a different period of coverage.
- The election change must be on account of and correspond with the change under the plan of the spouse or dependent (e.g., enrollment by a spouse or dependent in the other employer's plan).

Making/Changing Elections: COBRA Qualifying Events

- A cafeteria plan may permit an employee to make a mid-year election change if a COBRA event occurs to the employee, spouse or dependent.
- If still employed, employee may increase pre-tax salary reductions to cover the COBRA premiums.

Making/Changing Elections: Orders, Decrees, Judgments

- A cafeteria plan may allow mid-year changes on account of court orders resulting from divorce, legal separation, annulment, or change in legal custody.
- Example:
 - An employer receives a qualified medical child support order (QMCSO) requiring the employee to cover a dependent child.
 - The employee is allowed to change his election in order to cover the child.
- Note that a cancellation of coverage is permitted only if the order requires the employee's spouse, former spouse of other individual to provide coverage for the child, and such coverage is actually provided.

Making/Changing Elections: Entitlement to Medicare or Medicaid

- A cafeteria plan may allow mid-year election changes on account of eligibility of the employee, spouse or dependent for Medicare or Medicaid.
- Gaining Medicare or Medicaid allows the participant to cancel or reduce health coverage under the plan.
- Losing Medicare or Medicaid allows the participant to elect or increase coverage under the plan.

- A cafeteria plan may allow a mid-year election change on account of a leave of absence under the FMLA.
- Employer must allow all election changes otherwise available to employees on non-FMLA leave.
- The plan must allow participants to revoke health care coverage during the FMLA leave, and to reinstate coverage upon returning from the FMLA leave.
- If employee continues coverage during an FMLA leave, employer may allow three types of payment options: pre-pay, pay-as-you go, or catch-up upon return from the leave.
- This rule applies to health care FSAs.

Making and Changing Elections: HIPAA Special Enrollment

- The following events qualify as HIPAA special enrollment events:
 - Loss of eligibility for other group health coverage or individual insurance coverage
 - Loss of Medicaid/CHIP eligibility or becoming eligible for a state premium assistance subsidy under Medicaid/CHIP
 - Acquisition of a new spouse or dependent by marriage, birth, adoption, or placement for adoption
- Upon experiencing a HIPAA special enrollment event, the plan is required to allow the employee to select any medical benefit option available under the plan.
- Employees must have a period of at least 30 days from the date of the event to change their election pursuant to a HIPAA special enrollment event (60-day election period for loss of Medicaid/CHIP eligibility).

Making/Changing Elections: HIPAA Special Enrollment Events

- The general rule is that an election to enroll in coverage pursuant to a HIPAA special enrollment event must be effective no later than the first of the month following the date of the election change request
 - **Example 1:** Jack marries Jill on April 19, and he submits the election change request to enroll Jill on April 22. Jill's coverage must be effective no later than May 1.
 - **Example 2:** Jack marries Jill on April 19, but does not submit the election change request to enroll Jill until May 14. Jill's coverage must be effective no later than June 1.

Making/Changing Elections: HIPAA Special Enrollment Events

- Birth/Adoption: Coverage Retroactive to the Date of the Event
 - If an employee gains a new child through birth, adoption, or placement for adoption, coverage for the new child must be effective as of the date of the event.
 - **Example:** Jack's spouse Jill gives birth to a child on July 19. Jack submits the election change to enroll the child on August 14. The child's coverage must be effective as of July 19 (i.e., the date of birth)

Making/Changing Elections: HIPAA Special Enrollment Rights

- Existing Dependents: No Special Enrollment Rights
 - Upon birth, the rules limit the special enrollment rights to the employee, the spouse, and any newly acquired dependents (i.e., the newborn child)
 - Any other dependents (e.g., siblings of the newborn child) are not entitled to special enrollment rights upon the employee's acquisition of the new dependent through birth

Health FSAs: Summary of Permitted Mid-Year Election Change Events

| Change Permitted | No Change Permitted |
|--|--|
| <ul style="list-style-type: none">• Change in Status Event | <ul style="list-style-type: none">• Significant Cost Changes |
| <ul style="list-style-type: none">• Judgments, Decrees, or Orders | <ul style="list-style-type: none">• Significant Coverage Curtailment |
| <ul style="list-style-type: none">• Medicare or Medicaid Entitlement | <ul style="list-style-type: none">• Addition or Significant Improvement of Benefit Package Option |
| <ul style="list-style-type: none">• FMLA Leaves of Absence | <ul style="list-style-type: none">• Change in Coverage Under Other Employer Plan |
| <ul style="list-style-type: none">• COBRA Qualifying Events | <ul style="list-style-type: none">• Loss of Group Health Coverage Sponsored by Governmental or Educational Institution |
| | <ul style="list-style-type: none">• Pre-Tax HSA Contribution Changes |
| | <ul style="list-style-type: none">• Exchange Enrollment |

Making/Changing Elections: Exceptions Not Recommended

- Employees sometimes request mid-year election changes even though they haven't experienced a permitted election change event. There are at least three reasons for not allowing exceptions.
- Reason 1: Wholesale failure to adhere to the permitted election change event rules can cause the entire cafeteria plan to lose its tax-advantaged status
- Reason 2: Insurance carriers (and stop-loss providers) generally will pay claims only for employees and dependents who are eligible and properly enrolled
 - If a carrier discovers that an employee was allowed to enroll in any other situation, the carrier might deny paying all claims for that employee/dependent, making the employer responsible for self-funding all claims

Making/Changing Elections: Exceptions Not Recommended

- Reason 3: ERISA Plan Precedent
 - ERISA requires that employers administer the plan consistently and in accordance with the terms of the written plan document
 - The plan document will not permit employees to make election changes unless they experience a permitted election change event and make the election within the required timeframe
 - If the employer makes an exception, it is arguable that the employer has effectively interpreted the plan's terms to permit the exception, and this interpretation should be applied consistently for all similarly situated employees

Making/Changing Elections: Doctrine of Mistake

- IRS has provided informal guidance that an employee's election can be undone if there is "clear and convincing evidence" that a mistake has been made. Facts and circumstances must be compelling to qualify for this exception. The presumption is that the employee has just changed his/her mind.
- If the employer undoes the election based on the doctrine of mistake, the employer should:
 - Clearly document the reason for undoing the election (i.e., the facts supporting clear and convincing evidence of the mistake);
 - Require the employee to sign off on these facts; and
 - Be clear in any communication that it is only very rare circumstances like these that an employer could change or revoke an existing election without experiencing a permitted election change event

Coronavirus-Related Legislation Impacting FSAs

- IRS Notice 2020-29
 - Allowed mid-year changes to health benefits, health FSAs and/or dependent care FSAs without a change in status event
 - Optional for plan sponsors; could choose to offer for some or all covered benefits (e.g., offer for FSA but not health plan enrollment)
 - Allowed extension of plan year or grace period ending in 2020 through December 31, 2020
- IRS Notice 2020-33
 - Increased health FSA carryover from \$500 to \$550, and indexed to inflation going forward
- Plan amendments required by December 31, 2021
 - Can be retroactive to January 1, 2020 so long as eligible employees are informed of the changes.

Coronavirus-Related Legislation Impacting FSAs

- Consolidated Appropriations Act, 2021
 - Provides employers with two options to provide relief to employees with unused health and/or dependent care FSA amounts for plan years ending in 2020 and 2021:
 - Option 1: Add (or, in the case of a health care FSA, extend) a carryover feature to cafeteria plans that will allow participants to carry over any unused amounts remaining in a health and/or dependent care FSA at the end of the 2020 and 2021 plan years to the following plan year.
 - Option 2: Extend that grace period to 12 month after the end of the plan year. This increases the maximum grace period from 2½ months to 12 months for plan years ending in 2020 and 2021.
 - Both options give employees up to an extra 12 months to use leftover health and dependent care FSA amounts.

Coronavirus-Related Legislation Impacting FSAs

- Consolidated Appropriations Act
 - FSAs may be amended to permit employees who cease participation in a health care FSA during the 2020 or 2021 plan year (due to termination of employment, for example) to continue to receive reimbursements of unused FSA contributions for expenses incurred through the end of the plan year in which their participation ceased (including any extended grace period provided for under the plan's terms, as described above).

Coronavirus-Related Legislation Impacting FSAs

- Consolidated Appropriations Act
 - Temporarily increases the age for a qualifying dependent to a maximum age of 14 for the last plan year for which the regular enrollment period was on or before January 31, 2020 (in most cases, the 2020 plan year).
 - For a qualifying dependent who turned age 13 during the last plan year, the dependent care FSA may be amended to allow for reimbursement of expenses related to such child's dependent care for the remainder of the plan year.
 - The dependent care FSA can also be amended to allow participants to carry over unused amounts to the subsequent plan year and apply those amounts to the dependent care expenses until the dependent reaches age 14.

Coronavirus-Related Legislation Impacting FSAs

- Consolidated Appropriations Act
 - Permits employers to allow employees to elect or change an existing health or dependent care FSA election for the 2021 plan year, on a prospective basis, at any time during the year without a “status change” event.
 - Amendments for any of the FSA-related changes allowed under the Consolidated Appropriations Act must be adopted by the end of the first calendar year following the plan year in which the amendment is made effective.
 - For example, a plan adopting the carryover for plan year ending December 31, 2020 must adopt the related plan amendment by December 31, 2021.

Key Takeaways

- A cafeteria plan is the exclusive means by which an employer can offer employees an election between taxable income and nontaxable benefits on a tax-advantaged basis
- Must have a written plan document with specific content requirements
- IRC Section 125 imposes strict rules on when employees are permitted to make their elections, change them mid-year and the period during which their benefits may be used; allowing mid-year election changes is generally permissive; plan must specifically allow for the permitted mid-year election change events
- Violation of the IRC Section 125 rules can result in significant tax consequences
- Significant coronavirus-related guidance and legislation provides significant flexibility for 2020 and 2021