

To: Clients and Colleagues  
From: Chimento & Webb, P.C.  
Date: May 20, 2020  
Re: Section 125 Cafeteria Plans / Modification of IRS Rules

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1. **Background**

The IRS has issued two notices, IRS Notice 2020-29 and IRS Notice 2020-33 (together, the “Notices”) to allow employers to provide more flexibility to their employees as part of the Federal government’s ongoing response to the COVID-19 pandemic. The relief described in the Notices is at the discretion of the employer, but any measures adopted would be available to all eligible employees, including those not adversely affected by COVID-19.

The Notices make two temporary changes and one permanent change: they permit employers to amend their § 125 cafeteria plans (“Cafeteria Plans”) to: 1) allow participants to make mid-year changes to their elections for certain welfare benefits, a dramatic change from the standard principle of irrevocability of participant elections<sup>1</sup>; 2) permit participants an extended claims period for submitting eligible expenses incurred under health flexible spending arrangements (“Health FSAs”) and dependent care assistance programs (“DCAPs”) through December 31, 2020; and 3) increase, on a permanent basis, the carryover limit of Health FSAs.

Together, these Notices allow employers to offer employees both increased flexibility in changing their Cafeteria Plan elections to correspond to changes in health and dependent care needs brought on by the COVID-19 pandemic, and access to unused Health FSA and DCAP funds remaining from the 2019 plan year.

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<sup>1</sup> Prop. Reg. § 1.125-2

The relief provided in the Notices is extraordinary, but most of it is temporary. Employers should pay careful attention to the period of applicability for each of the changes described herein.

**2. Relaxation of the Irrevocable Election Rule**

Traditional Cafeteria Plan rules prohibit participants from revoking or changing benefit elections during a period of coverage (the 12-month plan year), subject to certain exceptions (and only if permitted by the written terms of the Cafeteria Plan).<sup>2</sup> The Notices outline relief from the standard rule to permit an employer to amend its Cafeteria Plan to allow eligible employees to make prospective election changes (including initial elections) regarding employer-sponsored health coverage, a Health FSA, or a DCAP, regardless of whether the basis for the election change satisfied the criteria set forth in IRS rules.

Specifically, an employer may amend its Cafeteria Plan to allow employees to:

1. Make a new election for employer-sponsored health coverage on a prospective basis;
2. Revoke an existing election for employer-sponsored health coverage and make a new election to enroll in a different health coverage option provided by the same employer (*e.g.*, switching from individual to family coverage);
3. Revoke an existing election for employer-sponsored health coverage on a prospective basis, subject to the attestation requirements described further below;
4. Revoke an election, make a new election, or decrease or increase an existing election on a prospective basis with respect to a Health FSA; and
5. Revoke an election, make a new election, or decrease or increase an existing election on a prospective basis with respect to a DCAP.

Although the Health FSA and DCAP deferral changes are prospective, the period of coverage remains unchanged. This means a participant who increases his or her election – or even begins participation in a Health FSA or DCAP mid-year – can apply any newly deferred funds to expenses that were incurred at any point in the plan year that begins on or after January 1, 2020.

Note that in order for an employee to revoke an existing election for employer-sponsored health coverage, an employer must receive a written attestation that the employee is enrolled, or immediately will enroll, in other non-employer-sponsored health coverage. An employer may rely upon such written attestation unless it has actual knowledge that the employee does not

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<sup>2</sup> Prop. Reg. § 1.125-4

intend to enroll in alternative health coverage. The IRS has provided an example of an acceptable written attestation.<sup>3</sup>

**This rule change is permitted only for plan years that begin in 2020** – for plan years beginning after December 31, 2020, the normal rule (that mid-year elections are allowed only during special enrollment periods as a result of a qualifying event) will apply.

**3. Increased Carryover Limit for Health FSAs**

The Health FSA carryover permits unused amounts remaining at the end of a plan year to be “carried over” in order to pay for eligible medical care expenses incurred in the following plan year. This limit has been \$500 since 2013.

The Notices permanently change how the carryover amount may be calculated so that it increases in step with increases to the Health FSA maximum contribution amount (which is \$2,750 for 2020). Employers can choose to amend their plans to allow a Health FSA carryover of 20 percent (20%) of the maximum salary reduction contribution under §125(i) each year. For plan years starting in 2020, a participant would therefore be able to carryover \$550 of 2020 Health FSA salary deferrals into the 2021 plan year.

**4. Extended Claims Period for Health FSAs and DCAPs**

Finally, the Notices give an employer the option to amend its Cafeteria Plan to permit an extended period for participants to utilize Health FSA and DCAP amounts that were elected in plan year 2019 but unused, and which would otherwise be forfeited.

Current IRS rules give Cafeteria Plans two options to allow participants to utilize unused Health FSA or DCAP amounts in a future plan year. Carryover amounts, as described in Section 3, permit a Health FSA participant (DCAPs cannot utilize the carryover rule) to apply up to \$550 (for the 2020 plan year) in unused amounts to eligible expenses incurred in the following plan year. Alternatively, Cafeteria Plans may allow a “grace period” following the end of a plan year, permitting a participant to apply unused Health FSA or DCAP amounts to pay qualified expenses incurred in the period of up to 2 ½ months after the end of the plan year.

Regardless the option a plan uses, the Notices permit an employer to amend its Cafeteria Plan to allow employees to use amounts remaining in a Health FSA or DCAP at the end of either a carryover or grace period to reimburse qualified expenses incurred through December 31, 2020. This extended time applies to unused amounts as of the end of a grace period ending in 2020 or a plan year ending in 2020.

Example: Joe Smith, a participant in a DCAP with a plan year ending on December 31, elects to contribute \$2,000 for the 2019 plan year. The DCAP has a

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<sup>3</sup> Notice 2020-29, pp. 8

grace period ending 2 ½ months after the end of the plan year, or March 15. As of March 15, 2020, Joe has used only \$1,000 of his 2019 election. However, Joe's employer amended its Cafeteria Plan to permit an extended claims period for its DCAP, as permitted by the Notices. Accordingly, Joe may use the \$1,000 remaining from his 2019 election to pay or reimburse qualified expenses incurred through December 31, 2020.

A plan sponsor may amend the plan to allow this extra time even if the plan does not normally provide a carryover or grace period, so that funds otherwise forfeited from the 2019 year would be available in 2020 for participants.

This additional time will allow employees the opportunity to make full use of any salary deferral elections so that unused amounts are not forfeited under the "use-it-or-lose-it" rules that typically apply to Cafeteria Plan elections.

**5. Effective Dates and Deadline for Amendment**

An employer must adopt an amendment to its Cafeteria Plan to provide for mid-year election changes for group health coverage, Health FSAs, or DCAPs, or to permit an extended claims period for Health FSAs and DCAPs. Changes in plan administration and operation can begin immediately, but plan documentation must be updated prior to the end of next year.

To be effective for the 2020 plan year, an amendment must be adopted on or before December 31, 2021, and may be effective retroactively to January 1, 2020.

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