Section 125 Cafeteria Plans - Modification of Permissive Carryover Rule for Health Flexible Spending Arrangements and Clarification Regarding Reimbursements of Premiums by Individual Coverage Health Reimbursement Arrangements

Notice 2020-33

I. PURPOSE

This notice modifies Notice 2013-71, 2013-47 IRB 532, to increase the carryover limit (currently $500) of unused amounts remaining as of the end of a plan year in a health Flexible Spending Arrangement (health FSA) under a § 125 cafeteria plan that may be carried over to pay or reimburse a participant for medical care expenses incurred during the following plan year. The increase in the amount that can be carried over from one plan year to the next reflects indexing for inflation, and this indexing parallels the indexing applicable to the limit on salary reduction contributions under § 125(i) of the Internal Revenue Code (Code). Second, this notice clarifies the ability of a health plan to reimburse individual insurance policy premium expenses incurred prior to the beginning of the plan year for coverage provided during the plan year. This clarification will assist with the implementation of individual coverage health reimbursement arrangements (individual coverage HRAs).

II. BACKGROUND

Section 125(d)(1) defines a § 125 cafeteria plan as a written plan maintained by an employer under which all participants are employees, and all participants may choose among two or more benefits consisting of cash and qualified benefits. Subject to certain exceptions, § 125(f) defines a qualified benefit as any benefit which, with the application of § 125(a), is not includable in the gross income of the employee by reason of an express provision of the Code. Qualified benefits include employer-provided

accident and health plans excludable from gross income under §§ 106 and 105(b), but exclude long term care insurance and certain qualified health plans offered through an Exchange (also referred to as a Marketplace) established under § 1311 of the Patient Protection and Affordable Care Act (the Act).[1]

Qualified health and accident benefits provided under a § 125 cafeteria plan and reimbursements of medical care expenses by an HRA or any other accident and health plan are subject to the rules for the exclusions from gross income under §§ 105 and 106. An amount generally will be treated as received under an accident and health plan only if the employee was covered by the plan on the date the employee became sick or injured. Treas. Reg. § 1.105-5. Thus, only reimbursements for medical care expenses incurred by a participant during the plan year may be excluded from income and wages under §§ 105 and 106.

Section 125(i) provides that, beginning in 2013, a health FSA is not treated as a qualified benefit unless the § 125 cafeteria plan limits each employee's salary reduction contribution to the health FSA to no more than $2,500 per taxable year (as indexed for cost-of-living adjustments, $2,750 for 2020).[2] Notice 2012-40, 2012-26 IRB 1046, clarifies that the term "taxable year" in § 125(i) refers to the plan year of the § 125 cafeteria plan, so that the limit is applicable beginning with the first day of the first plan year beginning in 2013.

A. The permissive carryover rule

Pursuant to § 125(d)(2)(A), a § 125 cafeteria plan generally does not include any plan that provides for deferred compensation. Consistent with this statutory rule,

[1] Public Law 111-148 (124 Stat. 1029 (2010)), amended by §§ 10104 and 10203 of the Act.
[2] Revenue Procedure 2019-44, 2019-47 IRB 1093.

proposed regulations under § 125 (that predate the enactment of the Act and provide that taxpayers may rely upon them pending further guidance) generally prohibit participants from using contributions made for one plan year to purchase a benefit that will be provided in a subsequent plan year because using contributions in this manner would result in a deferral of compensation. To satisfy the statutory requirement, and in reliance on the proposed regulations, plans adopted a "use-or-lose" rule under which unused benefits or contributions remaining as of the end of the plan year (referred to in this notice as "unused amount(s)") are forfeited. See Prop. Treas. Reg. §§ 1.125-1(c)(7)(C), 1.125-1(o), and 1.125-5(c). To address the need for a period after the end of the plan year during which participants may submit documentation for expenses incurred throughout the entire plan year, the proposed regulations provide for a "run-out period." A "run-out period" is a period immediately following the end of a plan year during which a participant can submit a claim for reimbursement of expenses incurred for qualified benefits during the plan year or, in the case of a plan using the grace period rule (described in the following paragraph), such a period immediately following the end of the grace period. See Prop. Treas. Reg. § 1.125-1(f). Plans commonly rely on this rule to calculate the unused amounts as of the end of a health FSA's plan year. The unused amounts are calculated as the amounts that remain after medical care expenses have been reimbursed at the end of the plan's run-out period for that plan year.

In 2005, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) liberalized the use-or-lose rule by providing a grace period rule. Under the grace period rule, a § 125 cafeteria plan may permit a participant to apply

unused amounts (including amounts remaining in a health FSA) to pay expenses incurred for certain qualified benefits during the period of up to two months and 15 days immediately following the end of the plan year. See Notice 2005-42, 2005-1 C.B. 1204, and Prop. Treas. Reg. § 1.125-1(e). This exception is based on other Code provisions and Treasury regulations that do not treat certain compensation arrangements as providing for deferred compensation if the compensation is paid no later than the fifteenth day of the third month after the taxable year in which the services are performed. See, e.g., Treas. Reg. § 1.404(b)-1T, Q&A-2.

Notice 2013-71 provided a further liberalization permitting a § 125 cafeteria plan to allow up to $500 of any unused amount in a participant's health FSA as of the end of a plan year to be paid or reimbursed to the participant for medical care expenses incurred in the immediately following plan year (the "permissive carryover" rule). In addition to the unused amounts of up to $500 that a plan may permit a participant to carry over to the next year, the plan may also permit the participant to elect up to the maximum amount of contributions through salary reduction permitted under § 125(i) for that year. Thus, under the liberalization provided through Notice 2013-17, the carryover of up to $500 does not count against, or otherwise affect, the indexed $2,500 limit on salary reduction contributions applicable to each plan year. Although the maximum unused amount allowed to be carried over in any plan year is $500, the plan may specify a lower amount as the permissible maximum carryover (and the plan sponsor has the option of not permitting any carryover at all).

Notice 2013-71, in permitting a carryover of $500, specified that a plan adopting a carryover provision is not permitted to also provide a grace period with respect to

health FSAs. Nor is the plan, for any plan year, permitted to allow a participant to elect a salary reduction contribution for health FSA benefits of more than the indexed $2,500 limit, or permitted to reimburse claims incurred during the plan year that exceed the applicable indexed $2,500 salary reduction contribution limit (and any nonelective employer contributions, often referred to as flex credits), plus the carryover amount of up to $500. If an employer adopts a carryover provision, the same carryover limit must apply to all plan participants. Also, a § 125 cafeteria plan is not permitted to allow unused amounts relating to a health FSA to be cashed out or converted to any other taxable or nontaxable benefit as this would result in deferral of compensation prohibited by § 125(a)(2)(A). Rather, unused amounts relating to a health FSA may be used only to pay or reimburse certain § 213(d) medical care expenses (excluding health insurance, long-term care services, or long-term care insurance). See Prop. Treas. Reg. § 1.125-1(q).

With respect to a participant, the amount that may be carried over to the following plan year is equal to the lesser of (1) any unused amounts from the immediately preceding plan year, or (2) $500 (or a lower amount specified in the plan). To prevent deferral of compensation, any unused amount in excess of $500 (or a lower amount specified in the plan) as of the end of the run-out period for the plan year is forfeited. Any unused amount in a participant's health FSA as of termination of employment also is forfeited (unless, if applicable, the participant elects COBRA continuation coverage with respect to the health FSA).

When Notice 2013-71 was issued, $500 represented 20 percent of the maximum allowed salary reduction amount under § 125(i). While the $2,500 maximum allowed

salary reduction amount is indexed for inflation under § 125(i)(2), Notice 2013-71 did not provide for any adjustment to the maximum $500 carryover amount. The indexed amount under § 125(i) for 2020 is $2,750.

On June 24, 2019, President Trump issued Executive Order 13877,[3] "Improving Price and Quality Transparency in American Healthcare to Put Patients First," which included an order that the Secretary of Treasury, to the extent consistent with law, issue guidance to increase the amount of funds that can carry over without penalty at the end of the year for flexible spending arrangements. In response to Executive Order 13877, the Treasury Department and the IRS are issuing this notice.

B. Timing of reimbursements by health plans

On October 12, 2017, President Trump issued Executive Order 13813,[4] "Promoting Healthcare Choice and Competition Across the United States," which included directions to the Secretaries of the Treasury, Labor, and Health and Human Services (the Departments) to "consider proposing regulations or revising guidance, to the extent permitted by law and supported by sound policy, to increase the usability of HRAs, to expand employers' ability to offer HRAs to their employees, and to allow HRAs to be used in conjunction with nongroup coverage." In response to Executive Order 13813, the Departments issued regulations allowing HRAs to be "integrated" with individual health insurance coverage or Medicare if certain conditions are satisfied.[5] These HRAs are referred to as individual coverage HRAs[6] and generally are designed

[3] 84 FR 30849 (June 24, 2019).
[4] 82 FR 48385 (Oct. 17, 2017).
[5] 84 FR 28888 (June 20, 2019).
[6] Treas. Reg. § 54.9802-4.

to reimburse employees for substantiated premiums for individual health insurance coverage and other medical care expenses.

Individual coverage HRAs are, nonetheless, employer-sponsored health plans and the exclusion from employees' gross income of reimbursements by these HRAs is subject to the requirements of §§ 105 and 106 and the underlying regulations. These requirements include the general rule that only payment or reimbursement for medical care expenses incurred by an employee during the plan year may be excluded from income and wages under §§ 105 and 106. Notwithstanding this general rule, as well as the rule prohibiting the deferral of compensation in a § 125 cafeteria plan, the Treasury Department and the IRS recognized certain practical difficulties and proposed a rule of administrative convenience that would permit amounts contributed by salary reduction from the last month of one plan year of a § 125 cafeteria plan to be applied to pay accident and health insurance premiums for insurance during the first month of the immediately following plan year, if done on a uniform and consistent basis with respect to all participants. See Prop. Treas. Reg. § 1.125-1(p)(5)(i) (upon which taxpayers may rely pending further guidance).

The restriction that a health plan may reimburse only medical care expenses incurred during the plan year raises analogous administrative issues in the case of an individual coverage HRA to the extent that a participant must pay, prior to the first day of a plan year, all or part of the premiums for individual health insurance coverage or Medicare during that plan year. Notice 2017-67, 2017-47 IRB 517, addresses these issues in the context of qualified small employer HRAs (QSEHRAs) under § 9831(d), which are arrangements similar to individual coverage HRAs. In particular, Q&A-52 of

Notice 2017-67 provides that, notwithstanding a general rule that a QSEHRA may not reimburse medical care expenses incurred before the eligible employee is provided the QSEHRA, a QSEHRA is permitted 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.

III. GUIDANCE - FSA CARRYOVER AMOUNTS

A. Indexing of maximum carryover amount

As discussed in section II.A., this notice expands the exception to the prohibition on providing deferral of compensation through a § 125 cafeteria plan described in Notice 2013-71, which provides that a § 125 cafeteria plan may allow up to $500 of unused amounts in a participant's health FSA as of the end of a plan year to be carried over to pay or reimburse the participant for medical care expenses incurred in the immediately following plan year. Specifically, this notice increases the maximum $500 carryover amount for a plan year to an amount equal to 20 percent of the maximum salary reduction contribution under § 125(i) for that plan year. Because, by statute, the increase to the § 125(i) limit is rounded to the next lowest multiple of $50, increases to the maximum carryover amount, as the result of that indexing, will be in multiples of $10 (20 percent of any $50 increase to the § 125(i) limit). Thus, the maximum unused amount from a plan year starting in 2020 allowed to be carried over to the immediately following plan year beginning in 2021 is $550 (20 percent of $2,750, the indexed 2020 limit under § 125(i)).

B. Deadline for a written § 125 cafeteria plan amendment to implement indexing of maximum carryover amount for 2020 (or a later year)

As a general rule, an amendment to a § 125 cafeteria plan to increase the carryover limit must be adopted on or before the last day of the plan year from which amounts may be carried over and may be effective retroactively to the first day of that plan year, provided that the § 125 cafeteria plan operates in accordance with the guidance under this notice and informs all employees eligible to participate in the plan of the carryover provision. Because § 125(d)(1) provides that a § 125 cafeteria plan must be a written plan,[7] a § 125 cafeteria plan offering a health FSA may not utilize the increased carryover amount permitted under this notice for a plan year that begins in 2020 (or a later year) unless the plan is written in a manner that incorporates the increase by reference or the plan is timely amended to set forth the increased amount. Accordingly, a plan may be amended to adopt the increased carryover amount for a plan year that begins in 2021, for example, at any time on or before the last day of the plan year that begins in 2021; see section III.C. for a special amendment timing rule for the 2020 plan year. The ability to amend a plan to increase the carryover limit does not include the ability to allow employees to make new elections under the plan (but see relief for the 2020 plan year in section III.C.).

C. Extended period for employee elections for 2020

The final and proposed regulations under § 125 set forth a framework for the timing and amendments of participant elections that ensure the plan meets the requirements of the Code, including that the plan not provide for deferred compensation. Generally, under those regulations, an individual must make § 125 cafeteria plan elections before the start of the plan year, and those plan elections must

[7] See also Prop. Treas. Reg. § 1.125-1(c).

be irrevocable during the plan year, with limited exceptions that include certain changes in status to prevent the elections from constituting a deferral of compensation in contravention of § 125(d)(2)(A). See Treas. Reg. § 1.125-4 and Prop. Treas. Reg. § 1.125-2. As a result, an individual would be unable to modify his or her election for a health FSA on or after the first day of the 2020 plan year of the § 125 cafeteria plan, notwithstanding that the § 125 cafeteria plan is being amended to adopt the increased carryover amount for the 2020 plan year.

However, the Treasury Department and the IRS are simultaneously issuing a notice that, among other things, for the remainder of 2020, allows employers to permit mid-year elections under a § 125 cafeteria plan regarding a health FSA, including the ability to make an initial election to fund a health FSA, provided the changes are applied only prospectively. See Notice 2020-29, 2020-22 IRB __. Although Notice 2020-29 permits this flexibility temporarily in response to the public health emergency posed by the 2019 Novel Coronavirus, Notice 2020-29 does not limit the relief to individuals affected by the pandemic. Accordingly, individuals who, during 2020, wish to increase their health FSA contributions, or begin to make health FSA contributions, as a result of the increased carryover amount permitted under this notice may do so in accordance with Notice 2020-29. Although only future salary may be reduced under the revised election, amounts contributed to the health FSA after the revised election may be used for any medical care expense incurred during the first plan year that begins on or after January 1, 2020.

With respect to the requirement to amend the written plan, Notice 2020-29 provides that an amendment under this notice for the 2020 plan year must be adopted

on or before December 31, 2021, and may be effective retroactively to January 1, 2020, provided that the employer informs all individuals eligible to participate in the § 125 cafeteria plan of the changes to the plan.

IV. GUIDANCE - TIMING FOR REIMBURSEMENTS BY HEALTH PLANS

As discussed in section II.B. of this notice, a health plan, including a premium-reimbursement plan in a § 125 cafeteria plan or an individual coverage HRA, may not reimburse medical care expenses incurred before the beginning of the plan year and qualify for exclusion from income and wages under §§ 105 and 106. Medical care expenses are treated as incurred when the covered individual is provided the medical care that gives rise to the expense, and not when the amount is billed or paid. This notice provides that a plan is permitted to treat 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. Thus, for example, an individual coverage HRA with a calendar year plan year may immediately reimburse a substantiated premium for health insurance coverage that begins on January 1 of that plan year, even if the covered individual paid the premium for the coverage prior to the first day of the plan year.

V. EFFECT ON OTHER DOCUMENTS

Notice 2013-71 is modified to increase the annual maximum carryover amount allowed for a health FSA consistent with the guidance described above.

VI. INTENT TO REVISE EXISTING REGULATIONS; RELIANCE

The Treasury Department and the IRS intend to revise Prop. Treas. Reg. §§ 1.125-1(o) and 1.125-5(c) to reflect the guidance in this notice. Until the proposed

regulations are so revised, taxpayers may rely upon the guidance provided in this notice, which is favorable to taxpayers.

VII. DRAFTING INFORMATION

The principal author of this notice is Christopher Dellana of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this notice, contact Christopher Dellana at (202) 317-5500 (not a toll-free call).