

Short Plan Year

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National Specialty Practices



Question: We are an applicable large employer (ALE) and we currently operate medical plans and other benefits on a plan year ending March 31st (current plan year ending March 31, 2023), but we want to amend our plan year to a calendar year plan so that our employees can better understand the timing and election of their benefits. They have been confused by our benefits operating on a fiscal year basis. When can we make this change and what compliance issues should we consider?

Summary:

Changing the plan year for welfare benefits plans raises a number of compliance issues. The proposed change must be analyzed under the Internal Revenue Code (Code) Section 125 Plan rules, the Employee Retirement Income Security

Act (ERISA), the Affordable Care Act (ACA), the Consolidated Omnibus Budget Reconciliation Act (COBRA), and the Medicare Reporting rules, and employee relations issues should be considered as well.

If you're considering a change to the plan year for your welfare benefit plans, there are many compliance issues to keep in mind.



Detail:

When you think about changing the plan year for your welfare benefit plans, there are many compliance issues to keep in mind.

A. Section 125 Plan – Premium Conversion Component

When you allow employees to pay for their portion of premiums for welfare benefits plans on a pretax basis, you do so through Code Section 125 plan (Section 125 Plan) also known as a cafeteria plan. The Code Section 125 proposed regulations¹ require that a Section 125 plan year must be 12 consecutive months and must be set forth in the written Section 125 plan document.² A short plan year, or a change in plan year that results in a short plan year, is permitted only for a valid business purpose.³ An example of a valid business reason in the proposed regulations is changing a plan year due to a change in insurance carriers.⁴ In this case, it would seem that changing a plan year to alleviate employee confusion about benefits would be a valid business reason.

The Section 125 plan document will need to be amended to create a short plan year. Under the Code Section 125 proposed regulations, amendments must be prospective.⁵ So, an amendment to change the current plan year to a calendar year plan year would need to be adopted prior to December 31, 2022 and would provide for a short plan year from April 1, 2022 to December 31, 2022 and the next full plan year would be January 1, 2023 to December 31, 2023.

However, if the Section 125 Plan has a health flexible spending account (Health FSA), we recommend that changing the plan year NOT be done in the middle of the

current plan year. Rather, we recommend that the short plan year run from April 1, 2023 to December 31, 2023 due to the myriad of issues that arise for a Health FSA if a 12 month plan year is truncated. See Section B below. The amendment should be adopted in accordance with the provisions of the Section 125 plan permitting the plan to be amended.⁶

B. Section 125 Plan – Health Flexible Spending Account Component

Health FSAs are particularly difficult to deal with when considering a short plan year. It is recommended that employers NOT shorten a Health FSA plan year that has already started. A short plan year that truncates a plan year that has already begun can result in forfeitures under the use it or lose it rule for Health FSAs. Health FSA claims that are incurred after the end of the short plan year cannot be reimbursed from that year's contributions.⁷

Employees usually make their Health FSA elections based upon their expected needs for the upcoming 12 month plan year. If they do not have that entire 12 month period to incur claims, they may be caught with balances that must be forfeited, and that can create a human relations nightmare for the employer. Employers are not permitted to refund the account balances to the employees. Forfeitures can be distributed to participants at the end of the short plan year on a pro rata basis, but not based upon which employees had account balances and which employees did not.⁸

If the Health FSA doesn't already have a grace period,

one could be added to the end of the short plan year to try to ease the forfeiture issue. This would provide an additional 2 ½ months at the end of the short plan year for participants to incur and submit claims following the end of the short plan year to spend down their account balances before they are forfeited.⁹ Alternatively, if the Health FSA doesn't have a grace period, the Health FSA could be amended to include the \$570 carryover provision.¹⁰ The carryover provision would permit participants to carry up to \$570 from the prior plan year into the short plan year and they could incur claims at any time during the short plan year to spend the \$570 that was carried over.

In addition to the above problem with causing unexpected forfeitures, if a Health FSA plan year is truncated, there may be participants who have spent all of their annual election based upon an expected 12 month plan year. Remember that under the uniform coverage rule, a participant's annual election must be available on the first day of the plan year.¹¹

Here's an example: Assume that a participant elects the maximum \$2,850 for his Health FSA for the plan year starting 4/1/2022 and the employer withholds \$237.50 per month from his paycheck. He schedules hip replacement surgery in July 2022 and uses the entire \$2,850 to pay for that surgery. If the plan year is truncated and shortened to a short plan year ending 12/31/2022, the employer has only withheld 8 months of monthly contributions of \$237.50 for a total of \$1,900, but the participant has spent \$2,850. The employer will have to make up the \$950 difference.


When amending the Section 125 plan to provide for a short plan year, the amendment must provide that the maximum Health FSA contribution is prorated for the short plan year period.¹² So for a short plan year from April 1 to December 31, 2022, the maximum contribution would be $\$2,850 \times 9/12 = \$2,137.50$.

C. ERISA

Section 3(39) of ERISA defines "plan year" as the calendar, policy or fiscal year on which the records of the plan are kept.¹³ Short plan years are allowed for valid business reasons. We do not have specific guidance about what constitutes a valid business reason under ERISA to support a change in plan year resulting in a short plan year. But it would seem that changing a plan year to alleviate employee confusion about benefits would be a valid business reason under ERISA as well as under the Code.

For any of the ERISA plans the client wants to amend to change the plan year:

- Amendments must be prepared and executed prior to the effective date of the change.
- Form 5500 filings will be required after the close of the short plan year (if they are filing only one Form 5500 under a wrap plan, then that is the one that will be required; if they are filing more than one Form 5500, then they would need to do one for each plan that has a short plan year).
- SMMs (or a new SPD) must be delivered to participants informing them of the change (within 210 days after the close of the plan year).



Employee Benefits Package

Summary of Benefits



If the employer uses the lookback measurement method and wants to realign the stability period to coincide with the new plan year, there will be overlapping stability periods for the first year.

- For the health plan, the new SMM or SPD must be issued within 60 days after the change.

D. ACA

If the employer uses the federal poverty line (FPL) affordability safe harbor, the plan year can have an effect on which poverty guidelines are used since the federal poverty line is defined as follows:

(19) *Federal poverty line.* The term “federal poverty line” means for a plan year any of the poverty guidelines (updated periodically in the Federal Register by the Secretary of Health and Human Services under the authority of 42 U.S.C. 9902(2)) in effect within six months before the first day of the plan year of the applicable large employer member’s health plan, as selected by the applicable large employer member.¹⁴

So an employer using the FPL affordability safe harbor will need to make sure it uses the correct FPL.

If the employer uses the lookback measurement method and wants to realign the stability period to coincide with the new plan year, there will be overlapping stability periods for the first year. For example, if an employee is currently in a stability period through March 31, 2023 and that employee does not average FT hours for the new stability period starting January 1, 2023 the employer

would need to make sure the employee was still eligible for coverage through March 31, 2023 (the end of the old stability period).¹⁵ An amendment to the lookback measurement policy is necessary to make this change.¹⁶

E. COBRA

COBRA rates must be set for a 12 month determination period that usually is the same as the plan year.¹⁷ Once the rate is set for a 12 month determination period, the employer cannot change the premium. If the employer’s COBRA rates are currently set from April 1, 2022 to March 31, 2023, the employer will need to hold COBRA rates at their current levels until at least March 31, 2023.

There is no official guidance about whether a COBRA determination period can be a short year (less than 12 months) to align with change in the underlying medical plan’s plan year. Caution should be exercised here given the explicit requirement for a 12 month determination period. In this case we think the safest course would be to have a long determination period from April 1, 2022 to December 31, 2023. In the alternative, the employer might consider doing a short determination period and change the rates at April 1, 2023 for a short determination period of April 1, 2023 through December 31, 2023. Legal counsel should be consulted and the safest course might be to use the long determination period if COBRA rates would go up on April 1, 2023 and the short determination period if rates

would have gone down.

F. Medicare Reporting

Employers with health plans that provide prescription drug coverage to individuals who are eligible for Medicare Part D must do an annual disclosure to the Centers for Medicare and Medicaid Services (CMS) informing CMS whether the plan's prescription drug coverage is creditable or non-creditable.¹⁸ The annual disclosure must be provided within 60 days of after the start of the plan year. So, the employer will need to be mindful of this requirement and do its Medicare Part D disclosure within 60 days of January 1, 2023.

G. Employee Relations Issues

If the employer truncates the current health plan year to

a short plan year of April 1, 2022 to December 31, 2022 it should consider the maximum out of pocket expense and deductible issues. If there are employees who are close to or have already met the plan's deductible and/or maximum out of pocket limits, and those limits reset as of January 1, 2023 those employees may be very unhappy about the limits resetting prior to April 1, 2023. The employer may want to provide credit toward these limits in the new plan year for amounts accrued during the short plan year. According to the IRS, this is permitted and will not cause a participant to be ineligible to contribute to an HSA in the year following the short plan year.¹⁹ The employer will want to obtain the agreement of the carrier or stop loss carrier before promising this type of credit.

Conclusion:

What seems like a simple idea, changing the plan years of welfare benefits plans, turns out to involve several compliance issues. Each of those issues must be analyzed to determine if the plan year can be changed, and if so, how best to accomplish the change. Under the Section 125 and ERISA rules, the change is only permitted if there is a legitimate business purpose. If the Section 125 Plan has a Health FSA as a component benefit, the change should not be made until the start of the next plan year. And, in addition to the legal considerations, the employer should consider the human relations issues of a short plan year as well.

References

- 1 - The regulations have been in proposed form since 2007, but the IRS has said that taxpayers may rely on the proposed regulations until final regulations are issued.
- 2 - Prop. Treas. Reg. 1.125-1(d)(1), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 3 - Prop. Treas. Reg. 1.125-1(d)(2)-(3), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 4 - Prop. Treas. Reg. 1.125-1(d)(4), Example 2, <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 5 - Prop. Treas. Reg. 1.125-1(c)(5), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 6 - Cafeteria plan nondiscrimination testing is also done on a plan year basis and so there will be a need for testing on the short year. Special rules also apply to who is treated as a highly compensated employee in a short year. The nondiscrimination testing issues should be addressed with the vendor or advisor performing that testing.
- 7 - Prop. Treas. Reg. § 1.125-5(e), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 8 - Prop. Treas. Reg. § 1.125-5(o)(2), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf> (in no case may the experience gains be allocated among employees based (directly or indirectly) on their individual claims experience).
- 9 - Prop. Treas. Reg. § 1.125-1(e), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 10 - IRS Notice 2013-71, <https://www.irs.gov/pub/irs-drop/n-13-71.pdf>.
- 11 - Prop. Treas. Reg. §1.125-5(d)(1), <https://www.treasury.gov/press-center/press-releases/Documents/section125.pdf>.
- 12 - IRS Notice 2012-40, <https://www.irs.gov/pub/irs-drop/n-12-40.pdf>.
- 13 - ERISA §3(39), 29 U.S.C. 1002, <https://www.law.cornell.edu/uscode/text/29/1002>.
- 14 - 26 C.F.R. §54.4980H-1(a)(19), <https://www.law.cornell.edu/cfr/text/26/54.4980H-1>.
- 15 - See IRS Notice 2014-49 <https://www.irs.gov/pub/irs-drop/n-14-49.pdf>.
- 16 - Short plan years previously could also require an additional Patient-Centered Outcome Research Institute (PCORI) fee filing and payment under the ACA. The PCORI fee, however, will no longer apply for plan years ending on or after Oct. 1, 2019. So the final filing of any PCORI fee would be for the plan year ending March 31, 2019 in this instance and there would be no requirement for filing for the short plan year ending December 31, 2019.
- 17 - 26 C.F.R. §54.4980HB-8, Q&A2, <https://www.law.cornell.edu/cfr/text/26/54.4980B-8>.
- 18 - See https://www.cms.gov/Medicare/Prescription-Drug-Coverage/CreditableCoverage/index.html?redirect=/CreditableCoverage/40_CCDisclosure.asp.
- 19 - IRS Notice 2004-50, Q&A 22, https://www.irs.gov/irb/2004-33_IRB#NOT-2004-50.



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