COMPLIANCE OVERVIEW

COBRA Rules: Health FSAs and HRAs

The Consolidated Omnibus Budget Reconciliation Act (COBRA) is a federal law that requires most employers to provide former employees and dependents who lose group health benefits due to a qualifying event with an opportunity to continue group health coverage for a limited period of time (usually 18 months).

In general, employers are aware of their COBRA obligations with respect to their health insurance plans. However, employers that maintain health flexible spending accounts (FSAs) and health reimbursement accounts (HRAs) also need to be aware of how COBRA applies to these plans. In addition, although health savings accounts (HSAs) are **not** subject to COBRA coverage requirements, an employer that offers a high-deductible health plan (HDHP) in connection with an HSA must comply with COBRA for the HDHP.

This Compliance Overview provides general information about the available rules that apply to health FSAs and HRAs under COBRA. It also includes applicable COVID-19-related relief, and the COBRA impact of such relief.

LINKS AND RESOURCES

- Employer's Guide to Group Health Continuation Coverage under COBRA
- IRS Notice 2015-87, addressing COBRA coverage for health FSAs
- IRS Notice 2002-45 and Notice 2015-16, addressing COBRA premiums for HRAs

Health FSAs

- In general, employers must offer COBRA coverage under a health FSA, unless an exception applies.
- In most cases, the COBRA coverage may be limited to the plan year in which the qualifying event occurs.
- Unspent health FSA funds that carry over are included in COBRA coverage but not in the COBRA premium.

HRAs

- ☑ In general, employers must offer COBRA coverage for HRAs for the maximum COBRA coverage period.
- ☑ Maximum reimbursement under COBRA coverage may be prorated during the year.

Health Flexible Spending Accounts (FSAs)

A health FSA is a tax-favored account, most typically offered under a cafeteria plan, that pays for or reimburses the qualified medical expenses of an employee and his or her spouse and dependents.

Obligation to Offer COBRA Coverage

In general, employers that offer health FSAs to their employees are required to offer COBRA coverage to qualified beneficiaries who would otherwise lose their health FSA coverage due to a qualifying event. However, ***this is subject to the special exception described below***. Many health FSAs qualify for this special exception.

Health FSAs that do ***not*** qualify for the special exception must offer COBRA coverage for the maximum coverage period applicable under COBRA. In these cases, individuals electing COBRA coverage must be allowed to re-enroll for health FSA coverage for subsequent plan years during open enrollment periods.

To qualify for the special exception, a health FSA must provide **excepted benefits** and the **COBRA premium** under the health FSA must meet certain minimums. Effective for 2014 and later plan years, health FSAs must generally qualify as excepted benefits to satisfy the Affordable Care Act's (ACA) market reforms.

If COBRA coverage must be offered for subsequent plan years because the health FSA does not qualify for the special exception, an employer's risk of loss increases due to the uniform coverage rule applicable to FSAs. Under the uniform coverage rule, a health FSA must reimburse expenses up to the participant's remaining annual benefit, even if the reimbursements are in excess of the participant's year-to-date contributions.

Special Exception

If a health FSA qualifies for the special exception, the employer is not required to offer COBRA coverage to certain qualified beneficiaries, and, for other qualified beneficiaries, the employer may limit the duration of COBRA coverage to the plan year in which the qualifying event occurs. Note, however, that **COVID-19-related relief may apply**. This relief, outlined in IRS Notice 2021-15, allows employers to permit employees who cease participation during the 2020 or 2021 calendar year to continue to receive reimbursements from unused health FSA amounts through the end of the plan year, including any grace period (or shorter period if the employer chooses).

A health FSA qualifies for the special exception if it satisfies all of the following conditions:

- ☑ The maximum annual benefit payable to any participant under the FSA does not exceed an amount equal to twice the participant's annual salary deferral election under the FSA (or, if greater, an amount equal to the participant's annual salary deferral election under the FSA, plus $500);
- ☑ Other group health plan coverage is made available by the employer, other than HIPAA-excepted coverage (for example, limited-scope dental and vision coverage); and
- ☑ The maximum annual benefit available under the health FSA is less than the maximum COBRA premium for a year. Often, this criterion is satisfied because the COBRA premium will either equal the maximum annual benefit or will be equal to 102 percent of the maximum annual benefit.

If a health FSA qualifies for the special exception, the plan sponsor:

- Is not required to offer COBRA coverage to qualified beneficiaries who have "overspent" their FSA accounts; and
- Must offer COBRA coverage to qualified beneficiaries who have "underspent" their FSA accounts, but the COBRA coverage may terminate at the end of the year in which the qualifying event occurs. (Note that COVID-19 related relief may apply.)

"Overspent" and "Underspent" FSA Accounts

An employer determines whether a participant has "overspent" or "underspent" his or her health FSA account by looking at: (1) the participant's maximum benefit for the plan year; (2) the amount of reimbursable claims submitted to the FSA for the plan year before the qualifying event; and (3) the maximum amount that the employer is permitted to charge for COBRA coverage under the health FSA for the remainder of the plan year.

Overspent

If the participant's maximum annual benefit minus the amount of the submitted reimbursable claims is less than the maximum COBRA premium that can be charged for the rest of the year, then the FSA is "overspent."

Underspent

If the remaining annual benefit (participant's maximum annual benefit minus the amount of submitted reimbursable claims) is more than the maximum COBRA premium that can be charged for the rest of the year, then the FSA is "underspent."

Consider the following example based on Internal Revenue Service (IRS) regulations:

> ***Example:*** An employee's maximum annual benefit under a health FSA for 2018 is $2,400. The employee experienced a qualifying event that was a termination of employment on May 31, 2018. As of that date, the employee had submitted $300 of reimbursable expenses under the FSA. Thus, the employee's remaining annual benefit is $2,100. The maximum amount that the FSA can require to be paid for COBRA coverage for the remainder of 2018 is 102 percent times 1/12 of the applicable premium for 2018, times the number of months remaining in 2018 after the date of the qualifying event. In this case, the maximum amount that the FSA can require to be paid for COBRA coverage for 2018 is $2,448. One-twelfth of $2,448 is $204. Because seven months remain in the plan year, the maximum amount that the FSA can require to be paid for the employee's coverage for the remainder of the year is seven times $204, or $1,428. Because $1,428 is less than the employee's remaining annual benefit ($2,100), the FSA is required to make COBRA coverage available to the employee for the remainder of 2018 (but not for any subsequent year).

COVID-19-Related Relief and COBRA Impact

Legislation enacted at the end of 2020 allows employers with health FSAs to adopt a special rule regarding **post-termination reimbursements from health FSAs** for employees who cease plan participation during 2020 or 2021. It also allows employers to permit employees to carry over unused amounts from the 2020 and 2021 plan years, and extend the grace period for plan years ending in 2020 and 2021, among other things. Employers have discretion in adopting some or all of the relief, and can determine the extent to which it is permitted and applied. The impact of this relief on COBRA coverage is as follows:

- If an individual is otherwise a qualified beneficiary with respect to coverage by a health FSA, the limited post-termination health FSA reimbursement period **will not prevent the individual from having a loss of coverage resulting in a qualifying event** (for example, by termination of employment or reduction in hours of a covered employee), and the relevant employer will be subject to COBRA's notice requirements.
- If an employer adopts a carryover or extended grace period under this relief, the maximum amount that the health FSA may require to be paid as the applicable COBRA premium **does not include unused amounts carried over or available during the extended grace period**. Thus, if a qualified beneficiary is allowed a carryover to a later plan year or an extended grace period, the applicable COBRA premium payable to provide access to the carryover amounts or the amounts attributable to the extended grace period for that later year or for the extended grace period is **zero**. In addition, amounts carried over or available during the extended grace period are included in the amount of the benefit that a qualified beneficiary is entitled to receive during the remainder of a plan year in which a qualifying event occurs.

Special Rules for Health FSA Carryovers

Health FSAs may be designed to allow **carryovers of up to $570** of unused amounts remaining at the end of the plan year, subject to the COVID-19-related relief above. In Notice 2015-87, the IRS provided that any carry-over amount is included in determining the amount of the benefit that a qualified beneficiary is entitled to receive during the remainder of the plan year in which a qualifying event occurs.

Also, if a health FSA allows carryovers of unused amounts for similarly situated non-COBRA beneficiaries, the health FSA must allow carryovers by similarly situated COBRA beneficiaries, subject to the same terms applicable to non-COBRA beneficiaries. However, the health FSA is not required to allow a COBRA beneficiary to elect additional salary reduction amounts for the carry-over period, or to have access to any employer contributions to the health FSA made during the carry-over period. In addition, the carryover is limited to the applicable COBRA continuation period.

> ***IRS Example (disregarding applicable inflation-adjusted amounts):*** An employer maintains a calendar-year health FSA which qualifies as an excepted benefit. Under the health FSA, during the open season, an employee may elect to reduce his or her salary by $2,500 for the year. In addition, the plan allows a carryover of up to $500 in unused benefits remaining at the end of the plan year. An employee elects a salary reduction of $2,500 for the year. The employee experiences a qualifying event that is a termination of employment on May 31. As of that date, the employee had submitted $400 of reimbursable expenses under the health FSA.

The employee elects COBRA continuation coverage and pays the required premiums for the rest of the year. As a qualified beneficiary, the former employee submits additional reimbursable payments in the amount of $1,600. At the end of the plan year, there is $500 of unused benefits remaining.

The qualified beneficiary is allowed to continue to submit expenses under the same terms as similarly situated non-COBRA beneficiaries in the next year, for up to $500 in reimbursable expenses. The maximum amount that can be required as an applicable premium for the carry-over amount for periods after the end of the plan year is zero. The maximum period the carryover is required to be made available is the period of COBRA continuation coverage. In this case, the period is 18 months and terminates at the end of November of the next year. Thus, the health FSA need not reimburse any expense incurred after that November.

Calculating the COBRA Premium

In general, the maximum COBRA premium is 102 percent of the cost to the plan for similarly situated beneficiaries who have not experienced a qualifying event. The IRS has not issued much guidance on calculating COBRA premiums, especially with respect to health FSAs and HRAs.

However, IRS regulations indicate that the maximum COBRA premium for health FSA coverage is based on the **annual coverage amount under the FSA**, which includes both employee and employer contributions. The regulations include the following example:

> ***Example:*** During an open enrollment period before the beginning of each calendar year, employees can elect to reduce their compensation during the upcoming year by up to $1,200 per year and have that same amount contributed to the health FSA. The employer contributes an additional amount to the account equal to the employee's salary reduction election for the year. Thus, the maximum amount available to an employee under the health FSA for one year is two times the amount of the employee's salary reduction election for the year. The employer determined that a reasonable estimate of the cost of providing coverage for similarly situated non-COBRA beneficiaries under this FSA is equal to two times their salary reduction election for the calendar year, and, thus, that two times the salary reduction election is the applicable premium.

Also, the IRS has clarified that the maximum amount that a health FSA is permitted to require to be paid for COBRA coverage (that is, 102 percent of the applicable premium) does not include unused amounts carried over from prior years (including any amounts as a result of COVID-19-related relief). The applicable premium must be based solely on the sum of the employee's salary reduction election for the year and any employer contributions. IRS Notice 2015-87 includes the following example for this rule:

> ***IRS Example:*** An employee elects salary reduction with respect to a health FSA of $2,000. The employer provides a matching contribution of $1,000. In addition, the employee carries over $550 in unused benefits from the prior year (note that effective for plan years beginning on or after Jan. 1, 2022, a maximum of $570 is allowed). The employee experiences a qualifying event that is a termination of employment on May 31.
>
> The maximum amount the health FSA is permitted to require to be paid for COBRA continuation coverage for the remainder of the year is 102 percent of 1/12 of the applicable premium of $3,000 ($2,000 of

> employee salary reduction election plus $1,000 of employer contributions) times the number of months remaining in the year after the qualifying event. The $550 of benefits carried over from the prior year is not included in the applicable premium.

Health Reimbursement Accounts (HRAs)

An HRA is a tax-favored, employer-funded arrangement that pays for or reimburses the qualified medical expenses of an employee and his or her spouse and dependents.

Obligation to Offer COBRA Coverage

In general, employers with HRAs are required to offer COBRA coverage to qualified beneficiaries who would otherwise lose their HRA coverage due to a qualifying event, even if the HRA includes a spend-down feature. Note that the obligation to offer COBRA coverage **does not** extend to qualified small employer health reimbursement arrangements (QSEHRAs).

Although HRAs sometimes qualify as FSAs, HRAs rarely meet the standards for the special exception described above that applies to the requirement to offer COBRA coverage under an FSA. Thus, employers with HRAs generally must offer COBRA continuation coverage beyond the current plan year for the maximum coverage period applicable under COBRA. However, unlike FSAs, HRAs are not subject to the uniform coverage rule. This significantly reduces an employer's risk of loss for an employee electing COBRA, because the maximum amount of reimbursement under an HRA may be prorated during the year.

If an employee elects COBRA coverage for his or her HRA, the employee must have access to the unused balance as well as any additional accruals provided to similarly situated employees, less any year-to-date reimbursements. Also, due to the ACA's reforms, most employers link employees' HRA eligibility with participation in the employer's group health plans. If an employer coordinates HRA eligibility in this way, it can design its COBRA practices so that a qualified beneficiary who chooses to elect COBRA coverage may only elect the HRA in connection with the group medical plan. Under this design, for example, qualified beneficiaries may elect COBRA coverage for the HRA/group medical plan or for the group medical plan only, but may not elect COBRA coverage for the HRA only.

Calculating the COBRA Premium

The maximum COBRA premium is 102 percent of the cost to the plan for similarly situated beneficiaries who have not experienced a qualifying event. When COBRA coverage is elected for the HRA/group medical plan, the COBRA premium would typically be the total of the premium for the HRA component plus the group medical plan component.

Under otherwise applicable rules, IRS Notice 2002-45 describes an acceptable calculation method that uses a **blended HRA premium** as follows:

> An HRA complies with the COBRA requirements for calculating the applicable premium . . . if the applicable premium is the same for qualified beneficiaries with different total reimbursement amounts available from the HRA. For example, if the annual additional reimbursement amount credited under an HRA is $1,000 and the maximum reimbursement amount remaining for two similarly situated qualified beneficiaries at the time of their qualifying events is $500 and $5,000, the applicable premium is the same for each individual.

In Notice 2015-16, the IRS recognized that it had not provided guidance on how to calculate the COBRA premium for HRAs. According to the IRS, its guidance in Notice 2002-45 provides that the COBRA applicable premium under an HRA **may not be based on a qualified beneficiary's reimbursement amounts available from the HRA**. Notice 2015-16, which was issued to invite comments on an unrelated ACA provision, states that the IRS is considering various methods for determining the cost of applicable coverage under an HRA, including:

- Determining the cost of applicable coverage under an HRA based on the amounts made newly available to a participant each year;
- Allowing employers to determine the cost of coverage by adding together all claims and administrative expenses attributable to HRAs for a particular period (separately for each level of coverage if the employer allocation differs by employee election, such as allocating $1,000 to the accounts of employees electing self-only coverage and allocating $2,000 to the accounts of employees electing family coverage) and dividing that sum by the number of employees covered for that period (at that level of coverage); or
- Permitting or requiring employers to use the actuarial basis method to determine the cost of coverage under an HRA.

Other Compliance Issues

COBRA compliance for FSAs and HRAs can be complicated, especially given the lack of IRS guidance. In addition to the COBRA compliance issues discussed above, the following topics are also linked with COBRA coverage under FSAs and HRAs:

- Applying the uniform coverage rule under FSAs during COBRA coverage;
- Determining when spouses and dependents have independent COBRA election rights;
- Calculating the remaining annual limit under an FSA; and
- Determining how to allocate continuing HRA accruals.

Employers sponsoring FSAs and HRAs should work with their advisors regarding COBRA compliance.