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BLOG

CAA Benefits Alert: Flexible Spending Account Guidance Clarifies Application of Consolidated Appropriations Act Changes

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The Internal Revenue Service (IRS) recently issued Notice 2021-15 (the Notice), which clarifies the provisions of the Consolidated Appropriations Act, 2021 (CAA) applicable to health and dependent care flexible spending accounts (FSAs), and provides additional relief for cafeteria plans. The Notice answers many questions that arose in applying the FSA changes permitted by the CAA provisions, and expands plan design flexibility for cafeteria plan sponsors. Our earlier discussion of the FSA relief in the CAA can be found here.

Clarification of FSA Carryover and Grace Period Rules

The Notice clarifies the application of the expanded FSA carryover and grace period rules in the CAA, and specifically addresses the amount allowed that may be carried over or accessed during the grace period, the ability to provide post-termination FSA reimbursements, the dependent age limit relief for dependent care FSA reimbursements, and the effect of an FSA carryover or extended grace period on an individual's eligibility to contribute to a health savings account (HSA). All of the changes permitted by the Notice are optional and may be adopted by plan sponsors in whole or in part.

Implementation of Expanded FSA Carryover or Extended Grace Period

The Notice confirms that the CAA provisions on FSA carryovers and extended grace periods only apply for the 2020 and 2021 plan years, and that there is no cap on the amount of unused FSA amounts that may be carried over or made available during a carryover or extended grace period. Thus, if a participant has unused funds in a health or dependent care FSA at the end of the 2020 (or 2021) plan year, the plan sponsor may either amend the FSA to allow the entire unused amount to carry over to the 2021 (or 2022) plan year or extend the grace period to the last day of the 2021 (or 2022) plan year. Under the Notice, for plan years ending in or after 2022, the existing cap on carryovers for health FSAs goes back to $550, as indexed, and the carryover ceases to be an option for dependent care FSAs. The Notice also clarifies that amounts carried over or available during an extended grace period are not taken into consideration for purposes of the cafeteria plan or dependent care FSA nondiscrimination tests.

For additional flexibility, a plan sponsor may choose to impose a cap on the amount carried over or available during a grace period. In addition, a plan sponsor may choose to have the carryover from one plan year apply to a date that ends prior to the end of the following plan year, or to extend a plan year's grace period to less than 12 months.

Under the relief provided by the Notice, an FSA may only have either a carryover or grace period for a given plan year and is prohibited from having both. For example, if a plan provides for a carryover from the 2021 plan year to the 2022 plan year, the plan may not also have a grace period for the 2021 plan year (that would allow 2022 expenses to be reimbursed from the remaining 2021 FSA balance). However, a plan sponsor could adopt a carryover for the health FSA and an extended grace period for the dependent care FSA. In addition, the plan sponsor may adopt a carryover for the 2020 plan year, and then amend the plan for the 2021 plan year to remove the carryover and adopt an extended grace period for the 2021 plan year.

Winston Takeaway: *The unlimited FSA carryover and extended grace period features allow participants to utilize amounts deferred in the 2020 plan year that they were unable to use due to a decrease in reimbursable medical or dependent care costs as a result of the pandemic. Plan sponsors should begin thinking about the carryover vs. extended grace period plan design options for the 2021 plan year based on whether participants accumulated significant unused amounts at the end of the 2020 plan year. Since participants have already made FSA elections for the 2021 plan year, the IRS has provided additional relief to allow participants to change health and dependent care FSAs mid-year as discussed below.*

Post-Termination Reimbursements from Health FSAs

The Notice permits plan sponsors to amend their FSA plans to allow terminated participants to receive reimbursement from a health FSA of eligible expenses incurred after the date of termination but before the end of the plan year (or grace period, if applicable) in which the participant ceased participation. This feature was previously available under dependent care FSAs, but not health FSAs unless the participant elected COBRA. The plan sponsor has flexibility on how to administer this feature and can limit the time period for receiving post-termination reimbursements to a date prior to the end of the applicable plan year or grace period.

Plan sponsors may also limit the amount of reimbursed post-termination expenses to the amount of salary reduction contributions made by the terminated participant to the health FSA from the beginning of the plan year to the date the participant ceased participation in the health FSA.

Winston Takeaway*: Plan sponsors offering health FSAs with grace periods may either allow post-termination reimbursements through the end of the plan year, including the grace period, or end the ability to receive reimbursement as of a participant's termination date. Thus, practically speaking, a 2020 terminated participant in a plan with a grace period who has an unused balance at the end of the 2020 plan year may be able to incur and submit claims for reimbursement until the end of the 2021 plan year. This feature is not available if the plan sponsor adopted a carryover feature instead of a grace period.*

Special Dependent Age Limit Option for Dependent Care FSA Reimbursements

Under the Notice, plan sponsors may increase the maximum age of a dependent for whom dependent care assistance expenses are eligible for reimbursement from 13 to 14. The Notice clarifies that adoption of this change is optional and that a plan sponsor need not adopt a carryover or extended grace period to take advantage of this relief.

This special rule applies only to plan years with an annual enrollment period ending on or before January 31, 2020 (the "relevant plan year"). For calendar year plans, the relevant plan year is the 2020 calendar year. This relief is available only if an employee participated in the dependent care FSA in the relevant plan year, had a dependent child who turned age 13 during the relevant plan year, and had an unused dependent care FSA balance on the last day of the relevant plan year. For such an employee, the leftover dependent care FSA balance could be used to

reimburse child care expenses for a dependent child under age 14 during the relevant plan year. Thus, if a plan sponsor with a calendar year plan has adopted an extended grace period feature for the 2020 plan year or a carryover feature from the 2020 plan year to the 2021 plan year, the remaining dependent care FSA balance from the 2020 plan year (but not any new 2021 contributions) could also be used to reimburse child care expenses for a dependent child under age 14 during the 2021 plan year.

Winston Takeaway: *This is a very limited exception that will be difficult to communicate to employees. Plan sponsors should determine whether the dependent care FSA participant population has dependents of an age that could benefit from this relief. If a plan sponsor is considering offering this relief, it should discuss the implementation of the relief with the third-party administrator to ensure the administrator can facilitate this change.*

Relief Allowing Plan Design Changes to Preserve HSA-Eligibility

The Notice makes clear that an individual is not eligible to make HSA contributions during a month in which the individual participates in a general health FSA that (i) has amounts carried over from a previous plan year, or (ii) gives the participant the ability to incur reimbursable claims during a grace period. This applies to active health FSA participants as well as terminated or former participants in the general health FSA who are eligible to receive reimbursement from the general health FSA due to a carryover or grace period feature. If an individual has health FSA coverage and wants to make contributions to an HSA, the individual may only have coverage under an HSA-compatible health FSA.

However, the Notice provides options for plan sponsors to allow flexibility for participants in this position. First, plan sponsors may amend their general health FSA to allow employees, on an employee-by-employee basis, to opt out of the carryover or grace period to preserve eligibility to make HSA contributions. In addition, plan sponsors may amend the general health FSA to allow employees to make a mid-year election change to be covered by a general health FSA for part of the year and an HSA-compatible health FSA for part of the year. A participant may want to take advantage of such a provision, for example, if the participant is enrolled in a general health FSA with a carryover feature in 2020, elects coverage under an HDHP for 2021, had a large unused general health FSA balance at the end of 2020 and incurred large general health FSA-eligible expenses in January 2021 while enrolled in the HDHP. In this example, the participant may want to forgo the ability to contribute to an HSA for the month of January 2021 in order to access the amounts carried over to the general health FSA from 2020 and then convert to an HSA-compatible health FSA for the remainder of 2021.

The Notice also allows a plan sponsor to transfer amounts from a general health FSA to an HSA-compatible health FSA if a participant who is covered by a general health FSA makes a mid-year change to be covered by an HSA-compatible health FSA, or vice versa. If a participant makes a mid-year change to an HSA-compatible health FSA, and transfers amounts from a general health FSA in conjunction with the change, the HSA-compatible health FSA can only reimburse expenses allowed by the HSA-compatible FSA and incurred on or after the effective date of the change in coverage.

Winston Takeaway*: Plan sponsors with HDHP/HSA plans who adopt the carryover or extended grace period relief should discuss with their service providers any administrative limitations to determine how these rules can be implemented. If there are participants who will be ineligible to contribute to a health FSA due to an extended carryover or grace period, the plan sponsor should consider amending the health FSA to give participants the option to elect an HSA-compatible FSA for a portion of the year, and a general health FSA for a portion of the year. Participant communications regarding an expanded carryover or extended grace period should discuss the impact on HSA-eligibility.*

Interaction with COBRA

The Notice confirms that terminated participants will still have a COBRA qualifying event even if the health FSA plan is amended to permit reimbursement of post-termination expenses. Thus, a terminated participant who loses group

health plan coverage due to a COBRA qualifying event must still be offered the right to elect COBRA even if they have access to health FSA amounts for post-termination reimbursements.

Unused health FSA amounts carried over or available during an extended grace period are not included when calculating the COBRA premium. In addition, if carryover or grace period funds are available to a qualified beneficiary after the COBRA period ends (i.e., after the end of the plan year that includes the qualifying event), the qualified beneficiary cannot be charged additional COBRA premiums to access those amounts – in other words, the applicable COBRA premium would be $0. A plan sponsor that does not amend its plan to provide for reimbursement of post-termination expenses as permitted under the CAA and the Notice may require a terminated participant to elect COBRA coverage to access unused amounts in a health FSA.

***Winston Takeaway**: Plan sponsors offering post-termination expense health FSA reimbursement in accordance with the CAA and the Notice should ensure terminated participants are still receiving any applicable COBRA notices. This is particularly important in light of the recent uptick in COBRA notice litigation. In addition, this could require coordination efforts between service providers since some plan sponsors have separate health FSA and COBRA administrators.*

Expanded Ability to Make Cafeteria Plan Election Changes

The CAA allows prospective changes to FSA elections during plan years ending in 2021. While changes to FSA contributions must be applied prospectively, the Notice specifically allows for expenses incurred at any time during the plan year – including for periods before an employee was an active FSA participant – to be reimbursed with those contributions. For example, a plan sponsor could allow an employee who was not enrolled in the dependent care FSA at the start of the plan year on January 1, 2021, to enroll in the dependent care FSA in March 2021, and the sponsor could use new contributions (as well as any carryover or available grace period funds from the prior 2020 plan year) to reimburse the employee for eligible dependent care expenses incurred in January or February 2021, prior to the employee's enrollment date. ***NOTE: After its initial publication, the IRS quietly re-issued Notice 2021-15 to clarify, in Section E. Elections Under a § 125 Cafeteria Plan, that all amounts available after a revised FSA election – including new contributions, carryover amounts, and amounts available due to an extended grace period – can be available to reimburse expenses incurred during the 2021 plan year.***

The Notice also clarifies that plan sponsors may limit mid-year FSA election changes to amounts no less than amounts already reimbursed to the participant, to allow only decreases in FSA election amounts or to make changes only during certain windows. If a participant revokes an FSA election, the plan sponsor may provide that amounts contributed prior to the revocation remain available to reimburse eligible FSA expenses for the rest of the plan year, or can limit reimbursement in that situation to expenses incurred before the revocation took effect.

***Winston Takeaway:** Plan sponsors offering HSA-eligible HDHP medical plan options should consider carefully how the cafeteria plan will be amended if offering the ability to revoke a health FSA election. If the plan treats a participant's revocation as terminating participation in the health FSA, or limits reimbursements after a revocation to expenses incurred before the revocation took effect, this will not adversely affect the participant's ability to contribute to an HSA. However, if the plan allows amounts contributed prior to the revocation to remain available to reimburse the participant's eligible FSA expenses for the rest of the plan year, this will render the participant ineligible to make HSA contributions.*

In addition, the Notice expands mid-year election change options (and extends the relief available in Notice 2020-86) by permitting plan sponsors to amend their cafeteria plans to allow prospective changes to elections for employer-sponsored health coverage (medical, dental and vision). Under these rules, if an employee initially declined participation in employer-sponsored health coverage, the employee may make a new election to enroll in such coverage on a prospective basis. An employee may also revoke an existing election for employer-sponsored health coverage and make a new election to enroll in a different health coverage option offered by the plan sponsor, on a prospective basis (including a change from self-only coverage to family coverage), or to revoke an existing election and drop employer-sponsored health coverage; provided the employee completes an attestation that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer.

Winston Takeaway: *Plan sponsors taking advantage of this expanded ability to allow cafeteria plan election changes have flexibility on how to structure these changes. For instance, the plan sponsor could implement a second open enrollment, and offer a one-time ability to make these changes, or the plan sponsor could allow unlimited changes throughout the plan year ending in 2021. Plan sponsors that allow unlimited opportunity for change will have increased administrative burdens, and it may also create more opportunity for adverse selection. In addition, fully insured plans and self-insured plans with stop loss coverage may be constrained by insurers from permitting these health plan election changes.*

Tax Relief for Amounts Reimbursed Due to Expanded FSA Carryover or Grace Period

The Notice provides helpful clarification for participants receiving reimbursements from a dependent care FSA as a result of a carryover or extended grace period. Specifically, the Notice provides that amounts carried forward from 2019 and used in 2020 are treated as amounts remaining available in a grace period under existing guidance, and notes that the IRS anticipates similar guidance to be issued for 2021 and 2022. Amounts remaining available in a grace period are not reported on the Form W-2 under existing guidance, and only new contributions are reported in Box 10 of Form W-2.

Winston Takeaway: *It was previously unclear under the Notice whether amounts received as reimbursement from a dependent care FSA in excess of the $5,000 limit per tax year due to a carryover or grace period would result in taxable income to the employee. The IRS has recently indicated informally that it will publish guidance on this issue which will clarify that use of prior year carryover or grace period amounts in a current tax year, resulting in dependent care FSA reimbursements in the current tax year in excess of the $5,000 limit, will not result in taxable income to the employee.*

Plan Amendments

The Notice follows the timing for plan amendments set forth in the CAA, and requires that plan amendments be adopted not later than the last day of the first calendar year beginning after the end of the plan year in which the amendment is effective. However, the plan must operate in a manner consistent with the terms of the amendment during the period beginning on the effective date of the amendment and ending on the date the amendment is adopted. For plan amendments to a calendar-year plan relative to the 2020 plan year, the amendment must be adopted by December 31, 2021.

Winston Takeaway: *This provides plan sponsors with ample time to amend plan documents to conform to administrative practice. Plan sponsors should ensure timely adoption of the plan amendment, as well as consistent plan operation and participant communications.*

Conclusion

The new guidance in the Notice is helpful for plan sponsors implementing or considering implementing the FSA relief provisions in the CAA. Plan sponsors should work with their service providers to facilitate plan design changes in line with the guidance that make the most sense given the plan sponsor's health offerings and participant population. Given that the flexibility in the guidance generally runs through the 2022 plan year, absent future extension of these provisions, plan sponsors taking advantage of the relief in the guidance should be prepared to return to the previous carryover and grace period rules beginning with the 2023 plan year.

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