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Employee Benefits Update

March 9, 2021

IRS Releases Guidance and Additional Relief for FSAs under the Consolidated Appropriations Act, 2021 with Notice 2021-15

Executive Summary

Notice 2021-15 (the "Notice"), released by the Internal Revenue Service on February 18, 2021, clarifies certain provisions of the Consolidated Appropriations Act, 2021 (the "CAA") that permit (but do not require) employers to provide enhanced flexibility to their health and dependent care flexible spending accounts ("FSAs") as a result of the COVID-19 pandemic. In particular, the CAA and the Notice permit the following FSA changes:

- Expanded carryovers of unused amounts and extended grace periods
- Reimbursements from health FSAs after participation ceases
- Reimbursements from dependent care FSAs after dependents turn age 13
- Section 125 cafeteria plan mid-year election changes without a change in status

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I. FLEXIBILITY FOR CARRYOVERS & EXTENDED GRACE PERIODS FOR UNUSED AMOUNTS

Current Law. Historically, health FSAs have permitted participants to use their unspent FSA funds after the end of a plan year by providing either a limited carryover of up to $550 of unused amounts from one plan year to the next, or a claims grace period of up to 2 ½ months following the end of the plan year, but not both. In contrast, dependent care FSAs have not been allowed to have a carryover feature, but they have been permitted to have a claims grace period of up to 2 ½ months following the end of the plan year.

Changes under CAA and the Notice. As part of the special targeted COVID relief under the CAA, employers may amend their health FSAs and/or dependent care FSAs to permit participants to carry over some or all of the unused amounts from 2020 to 2021, and from 2021 to 2022. The Notice clarifies that any unused amounts carried over during the extended period can only be applied to pay or reimburse eligible health or dependent care expenses, respectively.

Employers who decide to implement these expanded carryover features have the flexibility to:

- Adopt the carryover feature even if they previously did not have one (although employers should be mindful that if they adopt a carryover feature for their dependent care FSA for the 2021 and 2022 plan years when they previously had a grace period feature, they will need to revert to the grace period feature for the 2023 plan year)

- Adopt the carryover feature for some, but not all, participants (subject to FSA nondiscrimination testing requirements)

- Limit the carryover amount to less than the full unused balance existing as of the end of the prior plan year

- Require that employees enroll in the FSA in the current year, with a minimum election amount, in order to receive the carryover from the prior year

- Set a deadline by which the carryover amount must be used (i.e., requiring that the 2020 carryover amount be used by July 1, 2021)

- Permit the carryover to be available even if a participant enrolls in an FSA later in 2021, but only for expenses that are incurred prospectively, after the date of enrollment

Alternatively, the CAA provides that an employer may adopt an extended claims grace period of up to 12 months (rather than 2 ½ months) following the end of the plan year, in which participants can continue to incur expenses and be reimbursed from the unspent funds attributable to the prior plan year.

Each type of FSA can adopt either an extended grace period **or** expanded carryover, but not both. However, employers can treat the health FSA and dependent care FSA differently by adopting a carryover for the health FSA and a grace period for the dependent care FSA (or vice versa).

One cautionary note for employers considering an extended grace period for, or carryover into, a general purpose health FSA is the impact that these changes could have on the ability of employees to contribute to a Health Savings Account ("HSA"), because a participant cannot make contributions to an HSA while they are enrolled in a general purpose FSA, including if they are enrolled in that FSA due to an extended grace period or carryover of unused funds.

The Notice helpfully clarifies that amounts available during a carryover or extended grace period are disregarded for nondiscrimination testing and are disregarded for purposes of dependent care FSA W-2 reporting.

II. REIMBURSEMENTS FROM HEALTH FSAs AFTER PARTICIPATION ENDS

Current Law. Under current law, employees contributing to dependent care FSAs, whose employment terminates during the plan year, are able to continue to access their unused funds in the dependent care FSA through the remainder of the plan year. In contrast, terminating employees have only been able to continue accessing unused funds in a health care FSA through the remainder of the plan year if they make a COBRA election.

Changes under CAA and the Notice. Recognizing that many employees experienced a loss of employment or change in employment status (i.e., from full-time to part-time) as a result of the COVID pandemic, the CAA and the Notice permit employees who cease participation in a health FSA or dependent care FSA during the 2020 or 2021 calendar years to continue receiving reimbursements from unused amounts through the end of the plan year in which participation ceased, plus any regular or extended grace period following that plan year, without a COBRA election.

Under the Notice, if employers add this feature, they have the flexibility to limit the amount available during this spend-down period to the amount contributed to the FSA prior to the employee's cessation of participation (rather than the full annual elected amount), and they also may limit the post-termination participation period to the remainder of the plan year in which participation ceased (or any shorter period).

III. SPECIAL AGE LIMIT RELIEF FOR DEPENDENT CARE FSA CARRYOVERS

Current Law. Under current law, dependent care FSAs can reimburse qualifying dependent care expenses for participants' children until they reach age 13.

Changes under CAA and the Notice. The CAA and the Notice permit employers to continue reimbursing dependent care expenses for that limited group of participants who (i) were enrolled in the dependent care FSA for the last plan year for which the end of the regular enrollment period was on or before January 31, 2020 (i.e., the 2020 plan year for most calendar year plans), (ii) had one or more children who attained age 13 during that plan year, (iii) had unused dependent care FSA amounts for that plan year, and (iv) continue to incur qualifying dependent care expenses for those children during the next plan year until they reach age 14.

IV. SECTION 125 CAFETERIA PLAN MID-YEAR CHANGES

Current Law. Under current law, participant FSA elections are supposed to be irrevocable for the full 12-month plan year, with election changes permitted only upon certain qualifying status changes that are consistent with those changes, or in other limited circumstances.

Changes under CAA and the Notice. Like the pandemic-related changes made last year as part of the CARES Act, the CAA provides that, for plan years ending in 2021, cafeteria plans may permit participants to prospectively change their FSA elections, by making new elections; revoking existing elections; or increasing/decreasing FSA contributions, all without experiencing a change in status event. The Notice goes even further and expands

these mid-year changes so that employers can permit (but are not required) to allow their employees to do the following:

- Make a new election or enroll mid-year in health, dental, or vision coverage on a prospective basis.

- Change health, dental, or vision plan elections mid-year, or enroll a dependent into such plan options mid-year, on a prospective basis.

- Revoke health, dental, or vision plan elections on a prospective basis, provided the participant attests, in writing, that they are enrolled, or will immediately enroll, in other health coverage not sponsored by the employer. For this purpose, a participant attestation template is provided in the Notice that employers can rely upon, provided that the employer has no actual knowledge that the participant is not (or will not be) enrolled in other coverage.

Under the Notice, employers have the flexibility to (i) choose to limit election changes to increases or to new enrollments; (ii) limit the timeframe for making new elections; and (iii) limit the number of election changes an employee can make during the plan year. Implementing changes to non-FSA elections will require coordination with insurance carriers and with any third-party administrators supporting self-insured plans. Therefore, before implementing any of the changes permitted under the CAA and the Notice, employers should ensure that their insurance carriers and/or third-party administrators can support mid-year enrollment options that allow participants to change elections without experiencing a permitted or qualifying status change event.

V. RETROACTIVE AMENDMENT DEADLINES

If an employer decides to adopt any of the optional provisions described above, or to provide for the expanded reimbursement provisions for over-the-counter drugs and menstrual products previously permitted under the CARES Act, plans must be amended accordingly. Such amendments can be made retroactively, provided:

- The amendment is adopted no later than the last day of the first calendar year beginning after the end of the plan year in which the amendment is effective; and

- The plan is operated in manner that is consistent with the terms of such amendment for the full retroactive period – the period beginning on the effective date of the amendment and ending on the date the amendment is adopted.

For example, a calendar year cafeteria plan that adopts the full carryover provision, or the extended 12-month grace period, into 2021 must be amended no later than December 31, 2021. A non-calendar year cafeteria plan that adopts the full carryover provision, or the extended 12-month grace period, into 2021 must be amended no later than December 31, 2022.

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To discuss Notice 2021-15, the CAA, or any other employee benefits matter, please contact any member of our Employee Benefits and Executive Compensation Group below.

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