

Stimulus Legislation Allows Temporary Changes to Health and Dependent Care Flexible Spending Account Plan Rules

On December 27, 2020, the latest of several COVID-19 relief packages became law, as part of the Consolidated Appropriations Act, 2021 (the "New Law"). One of the most notable benefits-related provisions in the New Law relates to health and dependent care flexible spending accounts ("FSAs"). The changes to FSA rules in part expand on relief previously granted through Internal Revenue Service ("IRS") Notices 2020-29 and 2020-33 (the "Notices"), but also include several new provisions. (For more details on these Notices please see our prior alert linked [here](#).)

Background

Generally, a health or dependent care FSA must incorporate a "use-it-or-lose-it" rule under which unused benefits or contributions to the FSA remaining as of the end of a plan year are forfeited (subject to a "run out" period immediately following the end of the plan year where participants may submit documentation to request reimbursement of eligible expenses incurred during the plan year). Under pre-COVID IRS guidance, there have been two exceptions to this "use-it-or-lose-it" rule that cafeteria plans are permitted (but not required) to adopt.¹ They may utilize a grace period rule for health or dependent care FSAs that allows unused amounts to be available to pay for qualifying expenses incurred during the period of up to two months and 15 days following the end of that plan year, or they may utilize a carryover rule (for health FSAs only) which permits unused amounts remaining in an account at the end of a plan year (up to a specific dollar limit) to be used the following year. Note that a plan may adopt only one of these two exceptions.

Prior Relief

Notice 2020-29 generally permitted cafeteria plan sponsors to amend their plans to either provide an extended period to apply unused amounts remaining in a health or dependent care FSA as of the end of a grace period ending in 2020 or as of the end of a plan year ending in 2020, to pay for or reimburse qualifying expenses incurred through December 31, 2020. Notice 2020-33 generally permitted cafeteria plans to increase the maximum unused amount that may be carried over under health FSAs from \$500 to 20% of the current indexed health FSA pre-tax elective contribution limit for the year from which the amounts can be carried forward (thus \$550 for carryovers from 2020 into 2021).

New Relief

The New Law provides plan sponsors with two options for increasing participant flexibility with respect to using amounts deferred under a health or dependent care FSA, as well as permitting some leeway with respect to dependent care benefits and expanding options for election deadlines.

Carryover Expansion

The first option is that plan sponsors may amend their plans to permit employees to carry over any unused amounts under both health and dependent care FSAs from the plan year ending in 2020 to the plan year ending in 2021 and any unused amounts from the plan year ending in 2021 to the plan year ending in 2022. These carryover amounts

¹ See IRS Notice 2005-42 for the grace period rule and Notice 2013-71 for the carryover rule.

are not limited by the current \$550 cap that applies to carryovers from health FSAs. It appears that, as with the previously permitted, more limited, carryover amounts, this carryover will not reduce the salary reduction limit otherwise applicable to the plan year following the plan year in which the carryover was utilized.²

Grace Period Extension

The second option is that plan sponsors may amend their plans to provide an extended grace period (from the currently permitted two and a half months to up to 12 months after the end of the plan year) during which expenses can be incurred and applied against a prior year's elected FSA amounts for the plan years ending in 2020 or 2021. The carryover expansion and the grace period extension will both provide participants with a similar opportunity to utilize deferred amounts over a longer period of time; however, grace periods and carryover amounts interact differently with health savings accounts, therefore plan sponsors should consider their other benefit plans when deciding whether to utilize either of these forms of relief.

Additional Time for Terminating Participants

The New Law also permits, but does not require, plan sponsors to amend their health FSA plans to permit participants who cease participation in the plan in calendar year 2020 or 2021 to continue to receive reimbursements from unused benefits or contributions through the end of the plan year in which participation ceased (including any grace period, taking into account any extensions provided under the New Law). This is similar to rules which may currently be applied to dependent care FSAs.

Dependent Care FSA Age Change

Plan sponsors may also choose to temporarily liberalize the age limit for qualified dependent care expenses. This change would permit, but not require, plan sponsors to allow dependent care FSA participants to continue to receive reimbursements for a child's dependent care expenses for the remainder of a plan year after the child turns 13³ (provided the enrollment period for the plan year ended on or before January 31, 2020) and, if there were unused amounts in that plan year, continue to use any balance remaining during the following plan year until the child's 14th birthday. This liberalized rule can only be applied to plan participants who were enrolled in the dependent care FSA for the last year whose regular enrollment period ended on or before January 31, 2020 (so for most calendar year programs, the 2020 plan year), and who have a child who attains age 13 in that plan year (and if there were unused elected amounts in that plan year, in the next plan year).

Health and Dependent Care FSA Election Period Liberalization

Generally, elections under a cafeteria plan must be made prior to the first day of the plan year and must be irrevocable, except that plans are permitted, but not required, to allow employees to make election changes in limited circumstances, such as if the employee experiences a change in status or where there is a significant change in the cost of coverage. However, the New Law permits health and dependent care FSAs to permit prospective, mid-year changes in election amounts for plan years ending in 2021 without regard to change in status. It appears that this may include making an initial health or dependent care FSA election. Note that this is an optional change for plan sponsors.

² It appears that the New Law may not change the maximum amount that can be excluded from an employee's income (generally \$5,000 per year, but \$2,500 for married employees filing separately) as reimbursement of expenses for qualified dependent care assistance services provided during a tax year, or modify the nondiscrimination testing rules that apply to dependent care FSAs; however, we are hoping the IRS will issue clarifying guidance.

³ The existing exceptions for certain disabled children will continue to apply.

Amendments

These changes are optional, and amendments must be made to plans by the end of the calendar year which starts after the after the end of the plan year for which the amendment is effective, provided the plan was operated consistent with the terms of the retroactive amendment. Therefore, for changes that became effective with respect to a calendar year plan in 2021, the amendment must be made prior to the end of 2022, but for changes to be applied with respect to a calendar year plan with respect to the 2020 plan year, it appears that amendments would need to be adopted by the end of 2021.

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