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Employee Benefits and Executive Compensation Alert March 3, 2021

IRS Guidance on Additional Flexible Spending Account and Mid-Year Election Relief Under Cafeteria Plans in 2021 and 2020

On February 18, 2021, the IRS issued Notice 2021-15, which provides guidance with regard to a number of provisions of the temporary changes to the rules related to the operation of health and dependent care flexible spending accounts that were included as part of the Consolidated Appropriations Act, 2021 (the "New Law"), and also provides for an additional exception from the standard rules regarding Section 125 plan (often referred to as cafeteria plans or flexible benefits plans) election changes not found in the New Law. This alert reviews the changes made in the New Law, and highlights some of the additional guidance included in Notice 2021-15. (Our initial alert regarding the FSA-related provisions under the New Law is linked here.) The changes made by the New Law and the additional exception from standard rules provided under Notice 2021-15 with regard to election changes all continue to reflect optional provisions that plans can offer; the changes are not required to be implemented.

Carryover Expansion

Under the New Law, 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 are not limited by the current $550 cap that applies to carryovers from health FSAs. Notice 2021-15 confirms that, as with the previously permitted, more limited carryover amounts available for health FSAs, 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.[1]

A plan sponsor is permitted to require that a participant enroll in the health or dependent care FSA with a minimum election amount to have access to the carried over amounts permitted under the New Law. A plan sponsor can also limit the period during which the carried over amounts can be utilized – and require that they be utilized before a specified date earlier than the end of the year to which they are carried over.

Notice 2021-15 continues to apply prior guidance that if an amount from a general purpose health FSA is made available as a general purpose health FSA providing benefits in a later year because of a carryover of unused amounts, a plan participant would not be eligible to contribute to a health savings account (HSA) while covered by the general purpose health FSA. However, as with other carryovers, a plan could provide that a health FSA would provide only limited benefits (and become a limited purpose FSA) with regard to the carried over funds for participants who have elected high deductible health plan coverage in order to enable eligibility for HSA contributions by or for those participants for the period during which the carried over funds can be utilized. A plan sponsor could also enable plan participants to opt out of carryover of unused general purpose health FSA balances or permit participants to make a mid-year election change to be covered by a limited purpose health FSA for the remainder of the year to preserve HSA eligibility.

[1]It continues to appear that the New Law does 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.

Grace Period Extension

The New Law also permits plan sponsors to amend their plans to provide an extended grace period (from the normally 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 unused elected FSA amounts. The relief is only available with regard to elected amounts related to the plan years ending in 2020 or 2021.

The carryover expansion and the grace period extension can both provide participants with a similar opportunity to utilize unused remaining amounts over a longer period of time. However, there is one difference to note – if an employer wishes to allow health FSA participants to be eligible for reimbursement of health expenses after termination of employment (as permitted as described in the section below regarding the New Law), and the employer wants that reimbursement right to continue into the next following year, such a further extension of the reimbursement opportunity will only be possible if the employer has a grace period rule in place, rather than a carryover rule.

In addition, a plan can only permit one or the other (carryover or grace period) for each one of its particular health FSA or dependent care FSA programs – though it can allow different rules to apply to the health and dependent care FSAs (thus can use a grace period rule for a health FSA and a carryover rule for the dependent care FSA, or vice versa). A plan sponsor can also limit the availability of carryover or grace period rights to certain plan participants – though any such limitations on carryover or grace periods available would be subject to compliance with applicable nondiscrimination rules.[2]

Additional Time for Terminating Participants to Claim Health FSA Benefits

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 that apply under prior guidance for dependent care FSAs. As noted above, for those amounts to be available beyond the end of the plan year of termination of participation, the plan must have a grace period feature that extends into the next year; a plan with a carryover feature should not allow reimbursement for expenses incurred after the year in which participation ceased. Notice 2021-15 provides that a health FSA can also limit unused amounts available for reimbursement after termination of participation to unused amounts already funded through salary reduction contributions during the year plan participation otherwise ceased.[3]

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 13[4] (provided the enrollment period for the plan year ended on or before January 31, 2020) and, if there were unused amounts after all claims were made with respect to that plan year, continue to use any balance from that earlier

[2]Notice 2021-15 does indicate, however, that amounts carried over or available during a grace period will not be taken into account for purposes of the nondiscrimination rules that apply to Section 125 plans or the nondiscrimination rules that apply to dependent care assistance programs under Internal Revenue Code Section 129.
[3]This is different from the rule that would apply if a COBRA election were available and made, whereby if the participant continued to contribute to the program to enable coverage to continue after the COBRA event, the full elected amount could be eligible for reimbursement.
[4]The existing exceptions for certain disabled children will continue to apply.

year 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 (or if there still were unused elected amounts from that year (for a calendar year plan, the 2020 year) that had not already been used for a child who had attained age 13, who attains age 13 in the next plan year).[5]

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 and changes of coverage from a general purpose health FSA to a limited purpose health FSA[6] (or vice versa) in each instance, without regard to change in status. Notice 2021-15 confirms that that this may include making an initial health or dependent care FSA election. Note that this is an optional change for plan sponsors, and that plan sponsors can limit the time during the plan year ending in 2021 to make such changes, as well as the number of election changes that may be made, and can limit election changes to those changes that do not lower the elected level of coverage to amounts lower than the amounts already reimbursed.

New Election Change Opportunity under Notice 2021-15

In addition to the relief granted with regard to election changes that relate to contributions to health care and dependent care FSA accounts that was included in the New Law (and similar to the relief provided last year under Notice 2020-29), Notice 2021-15 also permits Section 125 plans to allow mid-year changes during the plan year ending in 2021 to elections with regard to health insurance coverage (whether fully insured or self-insured) without a related change in status.[7] However, an employer may not accept such a mid-year election to drop employer-provided health insurance coverage (rather than a change to a different health insurance coverage option or level of coverage (such as self-only or family coverage)) unless the employer receives a written attestation from the employee (and the employer does not have actual knowledge to the contrary) that the employee is enrolled, or immediately will enroll, in other comprehensive health coverage not sponsored by the employer.[8]

Amendments

These changes are optional. If one or more changes are implemented, amendments must be made to plans by the end of the calendar year which starts after the end of the plan year for which the change is effective provided the plan was operated consistent with the terms of the retroactive amendment. Therefore, for a calendar year plan, for changes that for all purposes became effective with respect to the 2021 plan year, 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, Notice 2021-15 confirms that amendments would need to be adopted by the end of 2021. For example, if an employer with a calendar year plan wishes to amend its plan to permit carryover of unused FSA amounts from 2020 to 2021, or a new or extended grace period into 2021 in which to incur claims related to calendar year 2020 elected amounts, that amendment will relate to the 2020 plan year and a plan amendment will be required to be adopted by December 31, 2021.

[5]Because complex rules apply with respect to this provision of the New Law, its administration will need to be carefully structured.
[6]Under the guidance, detailed rules apply to the types of expenses that may be incurred during periods before and after the change from one type of health FSA to another.
[7]For these purposes, election changes could be made with regard to health, dental or vision coverage.
[8]That other comprehensive coverage cannot be limited to dental or vision benefits.

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