GROOM LAW GROUP

www.groom.com

It's No Stretch to Say That IRS Guidance Makes FSAs More Flexible

PUBLISHED: February 25, 2021
UPDATED: March 8, 2021

On February 18, 2021, the IRS released Notice 2021-15 (the "Notice") interpreting section 214 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the "Act"), enacted as Division EE of the Consolidated Appropriations Act, 2021 (Dec. 27, 2020). Because the Act was signed into law with a mere four days left in 2020, but applies to FSAs with 2020 plan years, there had been much uncertainty and speculation as to how the IRS would interpret these provisions and whether IRS guidance would adopt stringent or complicated rules that limit the flexibility Congress seemed to intend. Fortunately, the IRS guidance is generally good news, as it presents a lot of plan design options for employers, clear rules for administrators and ultimately, if adopted by the employer, a path for FSA participants to avoid forfeiting their FSA dollars, even if those participants are also enrolled in Health Savings Accounts for 2021.

The highly-anticipated Notice provides the following temporary relief for health flexible spending arrangements ("HCFSAs") and dependent care assistance programs ("DCFSAs") (together, "FSAs"):

- Carryovers for plan years ending in 2020 and 2021;
- Grace period extensions for plan years ending in 2020 and 2021;
- Extended claims period for employees who cease participation in HCFSAs; and
- Special claims period and carryover for DCFSA dependents who "age out" during 2020 and 2021.

And, as a bonus, it also provides some additional flexibility for cafeteria plans:

- Special mid-year election changes for FSAs, as well as medical, dental and vision elections for plan years ending in 2021; and

If you have any questions, please do not hesitate to contact your regular Groom attorney or the authors listed below:

Katie Bjornstad Amin
kamin@groom.com
(202) 861-2604

David Block
dblock@groom.com
(202) 861-5427

Christine Keller
ckeller@groom.com
(202) 861-9371

Seth Perretta
sperretta@groom.com
(202) 861-6335

Malcolm Slee
mslee@groom.com
(202) 861-6337

This publication is provided for educational and informational purposes only and does not contain legal advice. The information should in no way be taken as an indication of future legal results. Accordingly, you should not act on any information provided without consulting legal counsel. To comply with U.S. Treasury Regulations, we also inform you that, unless expressly stated otherwise, any tax advice contained in this communication is not intended to be used and cannot be used by any taxpayer to avoid penalties under the Internal Revenue Code, and such advice cannot be quoted or referenced to promote or market to another party any transaction or matter addressed in this communication.

© 2021 Groom Law Group, Chartered • 1701 Pennsylvania Ave NW • Washington, DC 20006. All rights reserved.

- Clarification regarding the ability to add provisions to a cafeteria plan pertaining to the reimbursement of over-the-counter drugs and menstrual care products.

Below, we summarize the rules that normally apply (i.e., without application of the Act or Notice) and then how the Act and Notice change those rules for the applicable time period (generally, 2021 and 2022).

Carryovers

- General Rule – An employer can allow employees to carryover up to $550 (indexed) of unused HCFSA funds from one plan year to the next. Employees cannot carryover unused DCFSA funds.
- The Act – An employer can allow employees to carryover an unlimited amount of unused HCFSA and DCFSA funds from a plan year ending in 2020 to 2021 and a plan year ending in 2021 to 2022.
- The Notice –
    - An employer can adopt a carryover now even if the FSA did not previously have one, and can adopt a carryover for some, but not all, participants (subject to the nondiscrimination rules).
    - An employer can limit the carryover to an amount less than the full unused balance.
    - An employer can require that employees enroll in the FSA with a minimum election amount in the next plan year to receive the carryover and can set a deadline before the end of the plan year in which the employee must use the carried over amount (e.g., requiring a 2020 carryover to be used by June 1, 2021).
    - If an employee did not elect the FSA for the 2021 plan year, but later in 2021 elects to participate prospectively, the employee can receive the carryover from 2020 (if any). He/she can use the carried over amount to pay expenses incurred on or after January 1, 2021.

GROOM INSIGHT. For example, if an employee has an unused DCFSA balance as of December 31, 2020, but did not elect the FSA for the 2021 plan year because at open enrollment in the Fall of 2020 DCFSA carryovers were not permitted, the employer can permit the employee to enroll in the DCFSA now and can receive the carryover from 2020.

    - *Interaction with HSAs* – An employee is not eligible to contribute to an HSA if he/she has a carryover to a general purpose HCFSA. But, see HSA section below for relief.
    - *Interaction with Post-Termination HCFSA* – An individual covered under an HCFSA under the post-termination relief (described below) cannot receive a carryover.

- *Interaction with DCFSA Form W-2 Reporting* – An employer can report the salary reduction amount elected by the employee for the year, and does not need to adjust the amount reported based on amounts available during the carryover period.

GROOM INSIGHT. The Notice states that employees should report amounts carried over and used during the carryover period as amounts received on the carryover year's Form 2441 (the "Child and Dependent Care Expenses" form filed with the Form 1040). Based on the Notice, it appears that (for example) if an employee received $5,000 in reimbursements in 2021 from regular contributions and $1,000 in reimbursements from 2020 carryover amounts, $1,000 will be treated as taxable when he/she files his/her 2021 Form 1040. However, recent statements by IRS officials indicate that the IRS is considering taking the position that any carried over amount would not be taxable, even if the reimbursement for the year is in excess of $5,000. This issue should be monitored, and presumably the IRS will issue a revised Form 2441 for 2021 that will clarify their position.

- *Interaction with COBRA* – A COBRA qualified beneficiary has a right to the carryover, to the extent the carryover is offered to employees who are not COBRA qualified beneficiaries. And, the COBRA premium does not include the unused amounts available during the carryover period. Thus, the employer cannot charge a COBRA premium during the carryover period.

Extended Grace Periods

- General Rule – An employer can adopt a grace period of up to 2.5 months after the end of the FSA plan year in which participants can continue to incur claims and access the prior plan year's unused balance.
- The Act – An employer can adopt an extended FSA grace period of up to 12 months for plan years ending in 2020 and 2021.
- The Notice –
  - Employers can adopt an extended grace period now even if the FSA did not previously have one, and can adopt an extended grace period for some, but not all, participants (subject to the nondiscrimination rules).
  - An employer can adopt an extended grace period of less than 12 months if it would like.
  - *Interaction with HSAs* – An employee is not eligible to contribute to an HSA if he/she participates in a general purpose HCFSA during a grace period. But, see HSA section below for relief.

- *Interaction with Post-Termination HCFSA* – An individual covered under an HCFSA under the post-termination relief (see below) can access HCFSA amounts after the end of the plan year during a grace period.
- *Interaction with DCFSA Form W-2 Reporting* – Employers can report the salary reduction amount elected by the employee for the year and do not need to adjust the amount reported based on amounts available during the extended grace period (See "GROOM INSIGHT," above, regarding 2441 reporting).
- *Interaction with COBRA* - A COBRA qualified beneficiary has a right to the extended grace period, to the extent the extended grace period is offered to employees who are not COBRA qualified beneficiaries. And, the COBRA premium does not include the unused amounts available during the extended grace period. Thus, the employer cannot charge a COBRA premium during the extended grace period.

GROOM INSIGHT. The Notice clarifies that, similar to the current rules, an employer cannot adopt both a carryover and an extended grace period for the same HCFSA or the same DCFSA. But the employer can adopt a carryover for the HCFSA and an extended grace period for the DCFSA, and vice versa.

The Notice highlights that, practically speaking, the carryover and the extended grace period provide the same relief because both provisions allow any unused benefits remaining for plan years ending in 2020 and 2021 to be made available for the same benefit incurred in the immediately subsequent plan year ending in 2021 and 2022, respectively. However, as noted above, an individual covered under an HCFSA under the post-termination relief can only access HCFSA amounts after the end of the plan year during a grace period and cannot receive a carryover.

Post-Termination HCFSAs

- General Rule – An employer generally cannot allow an employee who ceases HCFSA participation mid-plan year to continue to receive reimbursements from the HCFSA unless he/she elects COBRA. Continued reimbursements are generally permitted post-termination, however, for a DCFSA.
- The Act – An employer can permit an employee who ceases HCFSA participation during calendar year 2020 or 2021 to continue to receive reimbursements from the HCFSA through the end of the plan year in which participation ceased.
- The Notice –
  - An employer can limit the amount available in the post-termination HCFSA to the amount of salary reduction contributions the employee has made from the beginning of

the plan year in which the employee ceased to be a participant up to the date that the employee ceased to be a participant (minus any prior reimbursements), rather than base the amount on the annual elected amount.

GROOM INSIGHT. This clarification makes this provision more attractive to employers. An employer can, however, base the balance on the annual elected amount if it would like to be more generous (e.g., in a furlough or layoff situation).

- This provision applies to employees who terminate participation for any reason, including due to termination of employment, change in employment status, or an election change.
- *Interaction with HSAs* – An individual is not eligible to make contributions to an HSA if he/she is a participant in a general purpose HCFSA during the post-termination period. But, see HSA section below for relief.
- *Interaction with COBRA* – This coverage extension does not prevent the employee from having a loss of coverage for COBRA purposes. Thus, if the loss of coverage is due to a COBRA qualifying event (e.g., termination of employment or reduction in hours), the employer must provide the COBRA election notice.

GROOM INSIGHT. The reason an employee would elect COBRA in lieu of receiving the post-termination HCFSA is that an employer cannot limit the available HCFSA balance under COBRA to amounts actually contributed, like it can under the special post-termination HCFSA rule under the Act. Rather, the COBRA balance is based on the annual elected amount (minus year-to-date reimbursements). Thus, an employee could end up in a better financial position if he/she elects COBRA, even though he/she has to pay COBRA premiums, depending on what point in the plan year his/her participation ceased and the amount of claims incurred.

One example in the Notice describes an employee who elects to contribute $2,400 to an HCFSA, and then terminates employment on January 31 after making $200 in contributions. If the employer adopts the post-termination HCFSA provision, it can limit the amount available post-termination to $200. Or, the employee can elect COBRA coverage and have access to the full $2,400 by paying the applicable COBRA premium of $200 per month.

DCFSA Age Limit Relief

- General Rule – A DCFSA participant can receive reimbursements for expenses incurred for a qualified child up to age 13.
- The Act – With respect to the last plan year that had an open enrollment period on or before January 31, 2020, an employer can allow DCFSA participants to receive reimbursements for the entire plan year for a qualified child who turns age 13 in such plan year. If a participant has an unused balance at the end of such plan year, employers can allow the participant to receive reimbursements during the subsequent plan year (but only up to the unused balance) for the qualified child (1) who turned age 13 in the prior plan year (until he/she turns age 14) and/or (2) who turns age 13 in that subsequent plan year.
- The Notice – An employer does not need to adopt a carryover or extended grace period to adopt this relief.

Election Changes

- General Rule – An employer can only permit an employee to change his/her FSA election under a cafeteria plan mid-plan year if he/she experiences a status change or other election change event.
- The Act – For plan years ending in 2021, an employer can permit an employee to change his/her FSA election mid-plan year, regardless of reason. (While the Act did not provide relief for elections related to other employer-sponsored health coverage, the Notice does provide additional such relief, described below.)
- The Notice –
    - An employer can permit an employee, on a prospective basis, to (1) revoke an FSA election, (2) make a new FSA election, and/or (3) increase or decrease an FSA election, for plan years ending in 2021 and 2022.
    - An employer can allow an employee to use the amounts contributed to the FSA after the election change to reimburse expenses incurred during the plan year prior to the change (even if the employee was not enrolled in the plan as of January 1, 2021).

GROOM INSIGHT. For example, if an employee first elects to participate in a calendar year FSA effective March 15, 2021, the employer can allow the employee to receive reimbursements for expenses incurred starting on January 1, 2021. This is a significant departure from the general FSA rules, which do not permit the FSA to reimburse expenses incurred before the employee was a participant. However, current rules do not prohibit an employee from increasing his/her election and receiving reimbursement for expenses incurred prior to the date the election was increased— any such limitations are the result of

plan design. This employee would be permitted to use any carryover from 2020 to reimburse expenses incurred on or after January 1, 2021.

- If an employee revokes his/her FSA election, whether or not he/she can continue to access the FSA balance for newly incurred expenses depends on the terms of the plan. The plan can provide that (1) the amounts remain available for the rest of the plan year, (2) the amounts are only available to pay expenses incurred prior to the change, or (3) the amounts are forfeited.

GROOM INSIGHT. There has been much confusion among employers and administrators since Notice 2020-29 was issued, which contained a similar change in election relief for FSAs. The specific question raised is whether an employer can allow an employer to access the prior FSA balance if he/she revokes his/her FSA election. The new Notice confirms that an employer can permit that (consistent with the plan's terms). Note this is different from a post-termination HCFSA because here, under the terms of the plan, the employee's participation does not end once the election is revoked – he/she continues to participate but simply has "zero" salary reduction for the remainder of the year.

- An employer can limit the period during which employees can make election changes (e.g., from June 1 – June 15) and limit the types of changes (e.g., decreases only).
- An employer can limit a reduction change to amounts no less than amounts already reimbursed.

GROOM INSIGHT. No cash-outs are permitted. To make this clear to employees, an employer may want to restrict the change to no less than the amount already contributed or the amount already reimbursed.

- While the relief under the Act was limited to FSA elections, the Notice provides relief beyond the Act and permits an employer, on a prospective basis for the first plan year that begins on or after January 1, 2021, to allow an employee to change an election with respect to medical, dental, and vision coverage. The employee can (1) make a new election, (2) change plan options for the same type of coverage (e.g., move from HDHP to non-HDHP or self-only to family), and/or (3) revoke an existing election and make a new election to enroll in the same type of coverage not sponsored by the employer (but

only if he/she attests in writing that he/she is enrolled, or will immediately enroll, in other health coverage).

HSA Interaction with Relief

- General Rule – Coverage under a general purpose HCFSA renders someone ineligible to contribute to an HSA, including during a carryover or grace period (if he/she has a balance as of the last day of the plan year). However, an employee who participates in a limited purpose HCFSA (that reimburses limited benefits such as vision or dental only) can remain HSA-eligible.
    - *Carryover* – Employers can permit employees to choose, on an employee-by-employee basis, to carry amounts from a general purpose HCFSA over to a limited purpose HCFSA or to opt out of the carryover.
    - *Grace Period* – Employers cannot permit employees to choose, on an employee-by-employee basis, to convert from a general purpose HCFSA to a limited purpose HCFSA during the grace period (but can convert for all participants) and cannot permit employees to waive grace period coverage.
- The Act – Did not address HSA interaction with other relief.
- The Notice –
    - If an employee revokes his/her general HCFSA election, and the plan does not permit the employee to reimburse expenses incurred under the HCFSA post-revocation, the employee can contribute to an HSA following the termination of participation.
    - An employer can allow an employee to make a mid-year election to be covered by a general purpose HCFSA for part of the year and a limited purpose HCFSA for part of the year, in which case his/her maximum HSA contribution is generally limited by the number of months in which he/she was HSA-eligible. The rules regarding these elections are:
        - From limited purpose HCFSA to general purpose HCFSA – Balance can transfer to general purpose HCFSA, but the general purpose HCFSA can only reimburse medical expenses incurred after the change to the general purpose HCFSA.
        - From general purpose HCFSA to limited purpose HCFSA – Balance can transfer to limited purpose HCFSA, but the HCFSA can only reimburse medical expenses incurred after the change to the limited purpose HCFSA.
        - Covered under HDHP with no HCFSA and then change to non-HDHP and general purpose HCFSA – general purpose HCFSA can reimburse expenses incurred while employee was covered by the HDHP, but only limited purpose expenses. The general purpose HCFSA can reimburse general purpose expenses incurred after the change to the non-HDHP.

- An employer can allow an employee (on an employee-by-employee basis) to choose between a limited purpose HCFSA and a general purpose HCFSA for the carryover or extended grace period.

GROOM INSIGHT. This is helpful relief because many employers were unable to adopt an extended grace period in 2020 (under Notice 2020-29) due to HSA concerns. The new Notice provides options to allow employers to adopt an extended grace period and still preserve employees' HSA eligibility.

Plan Amendments

- General Rule – Employers can amend cafeteria plans on a prospective basis only.
- The Act – If an employer chooses to adopt the FSA provisions, the employer can amend its cafeteria plan retroactively, as long as (1) the amendment is adopted not later than the end of the calendar year beginning after the end of the plan year in which the amendment is effective, and (2) the plan is operated consistent with the terms of such amendment during the period between when the change is effective and when the amendment is adopted.
- The Notice – Confirms that the amendment may be retroactive to the beginning of the applicable plan year, provided the plan operates in accordance with the terms of the amendment for the applicable period, and the employer informs all eligible employees of the changes to the plan.

GROOM INSIGHT. This is welcome news – since the Act was passed right at the end of the year, and we were waiting for clarifying IRS guidance, many employers and administrators were uncertain whether they could adopt a carryover or grace period related to a plan year that ended on December 31, 2020 after 2020 year-end.

Note that all of the Act provisions are optional, and an employer is not required to adopt any or all of them.

Over-the-Counter Drugs and Menstrual Care Products

- Current Rule – Per the CARES Act (passed in March 2020), for HCFSA and HRA (among other types of plans/accounts) purposes, expenses for over-the-counter drug and menstrual care products incurred after December 31, 2019 are excludable medical expenses.
- The Act – Did not address this rule.

- The Notice – Employers can retroactively amend HCFSAs and HRAs to provide for reimbursements of over-the-counter drug and menstrual care product expenses incurred beginning on or after January 1, 2020.

Conclusion

Although the Notice provides welcome flexibility, employers will need to decide what, if any, provisions they will adopt, and work with administrators to implement those provisions. Employers will also need to communicate those changes when adopted, but can wait until December 31, 2021 or December 31, 2022, as applicable, to adopt formal plan amendments.

If you have additional questions, please contact your Groom attorney, and we would be happy to discuss these issues with you further.