MY BENEFIT ADVISOR

IRS Guidance on Health FSA and DCAP Relief

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Section 214 of the Consolidated Appropriations Act, 2021 ("CAA") included optional and temporary relief for health flexible spending accounts ("health FSAs") and dependent care assistance programs ("DCAPs") offered in a Section 125 cafeteria plan ("cafeteria plan"). On February 18, 2021, the Internal Revenue Service ("IRS") issued Notice 2021-15 providing guidance addressing these optional plan changes.

Briefly, highlights from the guidance include:

- **Sec. 214 Health FSA and DCAP carryovers and extended grace period.**
  - The Sec. 214 carryover and extended grace period are only available for plan years that end in 2020 and/or 2021.
  - The amount available to carry over may be less than the full unused amount at the end of the plan year.
  - The length of the extended grace period may be shorter than the allowable 12 months.
  - The carryover or grace period extension will not affect the maximum FSA and DCAP salary reductions for the year.

- **Improved coordination with HDHP/HSA arrangements.** Notice 2021-15 provides welcome relief to help participants preserve eligibility to contribute to a health savings account ("HSA") when a health FSA includes a carryover or extended grace period. Employees would be able to "opt-out" of the traditional health FSA or make a mid-year election change to an HSA-compatible FSA.

- **NEW: Mid-year election change relief for group health plan coverage.** The guidance extends 2020 relief permitting mid-year election changes to prospectively enroll, disenroll, or change benefit options for group health plan coverage (medical, dental or vision) for plan years ending in 2021. Note, prior to adopting this relief, employers should obtain carrier (including stop loss carrier) approval.

- **Form W-2 Reporting for DCAPs.** Employers adopting the carryover or extended grace period relief for DCAPs will report the yearly salary reduction amount elected by the employee for the DCAP (plus any employer matching contributions). Employers are not required to adjust the amount reported in Box 10 due to the carryover or grace period.

- **NEW: Retroactive amendment permitted for health FSAs or HRAs that offer over-the-counter ("OTC") drugs and menstrual care products.** Plans may be retroactively amended to allow reimbursement of expenses incurred on or after January 1, 2020, for menstrual care products and OTC drugs without a prescription.

Additional details on the above are below.

Sec. 214 Health FSA and DCAP Carryovers & Extended Grace Periods

Traditional Rules

A health FSA may permit a carryover of unused amounts remaining in the health FSA as of the end of the plan year (up to $550). A carryover is not permitted in a DCAP.

A health FSA and/or DCAP may permit a participant to apply unused amounts at the end of a plan year to pay expenses incurred for qualified benefits during a period of up to two (2) months and fifteen (15) days immediately following the end of the plan year. This is known as the "grace period."

While inclusion of a carryover or grace period is not required, a health FSA may not have both a carryover and a grace period.

Sec. 214 Carryover and Extended Grace Period Relief

The Sec. 214 carryover relief allows an employer to amend the cafeteria plan to provide a carryover of all (or part of) the unused amounts remaining in a health FSA (including an HSA-compatible health FSA) or a DCAP as of the end of a plan year ending in 2020 and/or 2021 to the immediately subsequent plan year.

Under the extended grace period relief, an employer may amend the cafeteria plan to permit employees to apply unused amounts remaining in a health FSA or a DCAP as of the end of a plan year ending in 2020 and/or 2021 to reimburse expenses incurred for the same qualified benefit (medical care or dependent care) up to 12 months after the end of the plan year.

With respect to both the Sec. 214 carryover and the extended grace period, the following rules apply:

- The carryover and grace period are available to plans that currently have a grace period or provide for a carryover as well as plans that do not currently have these features. However, a plan may not have both a carryover and grace period. The plan amendment must specify which option is adopted for the applicable years.
- The amount available for carryover may be limited to less than all unused amounts and/or the employer may limit the carryover to apply only up to a specific date during the plan year.
- An employer may adopt an extended grace period that is less than 12 months.
- Amounts available because of the carryover and extended grace period will not impact the maximum salary reduction amount permitted in the calendar year.
  - For example, funds carried over from the 2020 plan year to a health FSA or DCAP will not impact an employee's ability to elect $2,750 and $5,000 respectively, for 2021.
- The employer may require employees to enroll in the health FSA or DCAP at a minimum election amount to have access to unused amounts from the Sec. 214 carryover or extended grace period.
- Amounts carried over or available during an extended grace period are not taken into account for purposes of the nondiscrimination rules.
- If the employer adopts the carryover or extended grace period for the health FSA, the COBRA premium associated with the health FSA may not include unused amounts carried over or available during the extended grace period.

Coordination with HDHPs and HSAs

Generally, a carryover or grace period in a "traditional" or "general-purpose" health FSA is an extension of coverage by a health plan that is not a qualified high deductible health plan ("HDHP") for purposes of determining whether an individual qualifies to make contributions to an HSA, except in the case of an HSA-compatible health FSA, such as a limited-purpose health FSA.

Notice 2021-15 provides welcome relief that allows an employer to amend the cafeteria plan in one of several ways to allow employees to maintain HSA eligibility as follows:

- Permit employees to opt out of the carryover or grace period on an employee-by-employee basis.

- Provide a mid-year election change that allows the employee to be covered by a general-purpose health FSA for part of the year and an HSA-compatible health FSA for part of the year.

- Permit each employee to choose between an HSA-compatible health FSA or general-purpose health FSA during the period when the Sec. 214 carryover or extended grace period applies.

- Automatically enroll employees who elect an HDHP into an HSA-compatible health FSA.

- To the extent changes result in an employee being ineligible for an HSA mid-year on a prospective basis, the employee would not be considered HSA ineligible for the earlier part of the plan year.

Mid-Year Election Changes

Health FSA and DCAPs

Employers have the option to amend their cafeteria plan to permit employees to make prospective mid-year election changes for health FSAs and DCAPs for plan years ending in 2021 without a specific change in status event.

If adopted, an employee may make the following changes on a prospective basis with respect to health FSA and/or DCAP election for plan years ending in 2021:

- revoke an election,
- make one or more elections; or
- increase or decrease an existing health FSA or DCAP election.

A prospective election change may include an initial election to enroll in the health FSA and/or DCAP for the year. For example, an employee who initially declined to enroll in the health FSA, may make a prospective election to enroll in the health FSA to use a newly available Sec. 214 carryover or extended grace period.

The following applies with respect to these mid-year election changes:

- There is no "cash out" of the health FSA or DCAP permitted.

- Employers may limit mid-year election changes to amounts no less than amounts already reimbursed and to certain types of mid-year election changes, such as decreases in elections only.

- Employers may allow mid-year election changes without a status change up to a certain date (e.g., by March 31, 2021) during the plan year, but require a status change after that date.

- Employers may limit the number of election changes during the plan year that are not associated with a status change (e.g., allow only one election change in the 2021 plan year without a status change).

- Although salary reductions may only be applied prospectively under any revised election, employers may allow amounts contributed to the health FSA or DCAP after the revised election to be used for any medical care expense or dependent care expense, respectively, incurred during the first plan year that begins on or after January 1, 2021 through the end of the 2021 plan year.

If an employee's election under a health FSA or DCAP is revoked, then the employer may adopt one of the following rules on a uniform basis:

- Amounts contributed before the election is revoked remain available to reimburse healthcare expenses or dependent care expenses (respectively) incurred for the rest of the plan year; or

- The amounts will be available only to reimburse eligible expenses incurred before the revocation takes effect (and not expenses incurred later).

Group Health Plan Coverage

While not included in the CAA, the IRS is again granting relief permitting employers to amend their cafeteria plan to allow employees to make prospective election changes for group health plan coverage (medical, dental or vision coverage) to:

- Enroll if the employee initially declined to elect employer-sponsored health coverage for the plan year;

- Enroll in a different level of health coverage (e.g., self-only or family) and/or modify their health coverage plan option (e.g., HMO to PPO) under the employer's plan; or

- Revoke an existing election provided that the employee attests in writing that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer that is not coverage solely for dental or vision benefits. The Notice provides an example of an acceptable attestation that may be used.

Employers may also determine a timeframe and the extent to which prospective election changes are permitted and applied (provided such changes comply with the Section 125 nondiscrimination rules) and may limit election changes to circumstances where the employee's coverage will be increased or improved to avoid adverse selection.

The additional relief relating to employer-sponsored health coverage applies to employers who sponsor fully insured health coverage as well as those who sponsor self-funded health coverage.

It is important to note that nothing in the IRS guidance requires carriers or self-funded health plans (including stop loss insurance) to permit mid-year enrollment and/or coverage changes. Prior to implementing any mid-year election changes to the group health plan coverage, it is important to understand whether the carrier (including stop loss insurers) will allow for such changes mid-year.

Health FSA Spend Down

An employer may amend the health FSA to permit employees who cease participation in the health FSA during calendar year 2020 or 2021 to "spend down" their unused health FSA contributions through the end of the plan year in which participation ceased, plus any grace period thereafter (including an extended grace period). However, the Sec. 214 carryover relief (if adopted) will not apply after the end of the plan year in which participation ceased.

Notice 2021-15 clarifies:

- For this purpose, an employee may cease to be a participant because of a termination of employment, change in employment status, or a new election during calendar year 2020 or 2021.

- The employer may limit the unused amounts in the health FSA to the amount of salary reduction contributions the employee had made for the plan year through termination.

- If the employer offers this spend down feature, COBRA obligations still exist in the event the health FSA has a positive balance and the individual loses eligibility for the health FSA due to a termination of employment or reduction in hours.

Special Age Limit Relief- DCAP

Under this rule, if a dependent child reaches age 13 during the last plan year with respect to which the end of the regular enrollment period for the plan year was on or before January 31, 2020 (the "first plan year"), the employee can continue to receive reimbursements for such child's dependent care expenses for:

- the remainder of the first plan year and, to the extent a balance remains at the end of the first plan year,

- the following plan year until the child turns age 14 (but only with respect to the unused amount from the first plan year).

This relief appears rather limited. For a calendar year plan, it only applies with respect to the January 1, 2020 – December 31, 2020 plan year (the last plan year where the enrollment period was before January 31, 2020), and, with respect to the 2021 plan year, to any unused amounts from 2020.

This special age limit relief for certain dependents is separate from the Sec. 214 carryover relief and extended grace period relief. An employer that adopts the special age limit relief is not required to adopt the carryover or grace period extensions in order to adopt the special age limit relief.

The special age limit relief does not permit a DCAP to reimburse expenses for a child who is age 14 or older.

In addition, Notice 2021-15 affirms that employers are permitted under a DCAP to limit reimbursements to expenses incurred for the care of a dependent child who is under a specified age that is less than age 13.

Reporting Requirements for DCAPs

Generally, amounts contributed to a DCAP are required to be reported in Box 10 of Form W-2. Under existing guidance, employers may report in Box 10 the yearly salary reduction amount elected by the employee for the DCAP (plus any employer matching contributions) and are not required to

adjust the amount reported in Box 10 to take into account amounts that remain available in a grace period.

Notice 2021-15 extends this rule for Sec. 214 carryover and the extended grace period and will treat amounts carried forward or extended as an amount that remains available in the grace period.

The Treasury Department and the IRS anticipate that for the 2021 and 2022 Forms W-2 and 2441, instructions will provide for similar rules that DCAP amounts carried forward from prior years under this relief will be treated as amounts remaining available during a grace period for reporting purposes and no change to the reporting requirements will be necessary. Clarification as to how the individual may be taxed when the total benefits used in a calendar year exceed IRS thresholds would be welcome.

Plan Amendments

If any of the changes described in the CAA and Notice 2021-15 are implemented, the cafeteria plan must be amended 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.

- For a January 1, 2020 to December 31, 2020 plan year, this means an amendment must be adopted no later than December 31, 2021.
- For a non-calendar year plan that begins in 2020 (e.g., June 1, 2020 – May 31, 2021), this means an amendment must be adopted by December 31, 2022.

In addition:

- The plan must be operated in a manner consistent with the terms of such amendment during the period beginning on the effective date of the amendment and ending on the date the amendment is adopted.
- The employer must inform all employees eligible to participate in the plan of the applicable changes being adopted. In addition, ERISA notification requirements may apply to any amendment of a health FSA or group health plan that is subject to ERISA.

Retroactive Amendments for OTC Drugs and Menstrual Care Products

In general, retroactive amendments are not permitted in a cafeteria plan, health FSA, or health reimbursement arrangement ("HRA"). Notwithstanding this general prohibition, Notice 2021-15 allows for a retroactive amendment in a health FSA and/or HRA to provide for reimbursements of expenses incurred on or after January 1, 2020 for menstrual care products and OTC drugs without a prescription. This relief includes amendments made prior to the issuance of this Notice.

Employer Action

Employers should:

- Consider what, if any, changes they wish to implement to their Section 125 plans in accordance with the CAA and this guidance.
- Work closely with FSA vendors to ensure any adopted provisions are being administered in accordance with the requested changes.
- Communicate all amended provisions, terms, and conditions with employees and consider incorporating limits on the allowable changes.
- Confirm with insurance carriers, third party administrators and stop loss insurers (if applicable) if you are considering allowing a mid-year change in elections under the group medical, dental and/or vision plans that the changes can be implemented.