Compliance Services Alert

LOCKTON

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IRS clarifies aspects of recent FSA and cafeteria plan accommodations

We've previously written about the recent Consolidated Appropriations Act's (CAA) accommodations for employees with leftover health and dependent care flexible spending account (FSA) year-end balances from the FSAs' 2020 plan years. As we explained in our recent alert on the CAA, employers now have the opportunity – if they want it – to allow employees to carry over unused monies in health and dependent care FSAs from that 2020 plan year to 2021 (and from 2021 to 2022), or to extend the FSAs' grace period for those years from 2½ months to 12 months, and to permit other accommodations for employees.

The CAA, however, left unanswered many questions about the mechanics and tax consequences of these accommodations. The IRS has now issued a notice that describes the agency's interpretation of the new rules.

The good news is the IRS's guidance favorably addresses most of the lingering issues with respect to FSA extended grace periods and carryovers. That being said, employers will need to carefully consider the extent to which they want to adopt the new rules due to their administrative and employee communication challenges.

The accommodations employers may permit

The options employers have with respect to their FSAs include:

- Health and dependent care FSAs can choose to allow either an unlimited (in amount) carryover for unused amounts from 2020 to 2021, and/or from 2021 to 2022, or may add or extend a grace period that relates to the 2020 and/or 2021 plan years. The carryover or grace period may be for up to 12 months.

  Lockton comment: The employer may add a carryover or grace period relating to an FSA's 2020 plan year even if the FSA had no carryover or grace period in place at the end of 2020, provided the plan is amended by the end of the first calendar year following the plan year to which the carryover or grace period relates (i.e., the end of 2021, for calendar year FSAs, where the grace period or carryover will relate to 2020 plan year-end residual balances). This is a more accelerated amendment deadline than implied by the CAA.

- For FSA plan years ending in 2021, employers may allow employees to prospectively add, drop, increase, or reduce FSA coverage without a change in status event.

Lockton comment: Mirroring the IRS's accommodations granted last summer for the 2020 calendar year, the IRS will also permit employers to allow, during their cafeteria plan's plan year ending in 2021, nearly unlimited prospective election changes that relate to comprehensive medical coverage (such as adding coverage, changing coverage options and tiers), and will even allow employees to drop employer health coverage if they attest they are getting coverage elsewhere (such as a spouse's employer's plan, an ACA marketplace, TRICARE, or Medicare).

Importantly, an employer can limit the period during which election changes can be made, the number of election changes, and apply other restrictions to reduce the risk of adverse selection, such as not permitting an employee to opt into a richer benefit option or reduce an FSA election for the current year below the amount of reimbursements the employee has already received for the year. The employer may allow election changes for some employees and not others, subject to concerns related to discrimination in favor of highly compensated employees.

An amendment allowing for midyear election changes in calendar year 2020 may be adopted retroactively but must be adopted by Dec. 31, 2021. An amendment allowing midyear election changes during the plan year ending in 2021 may be adopted retroactively, as long as it is adopted by the end of the calendar year beginning after the end of that plan year (or Dec. 31, 2022, for calendar year plans). However, employers may want to consolidate this amendment, related to the plan year ending in 2021, with one addressing changes for which the amendment is due by Dec. 31, 2021, and in that event the amendment should be adopted by the earlier deadline.

- A special accommodation allows employees with dependent care FSA balances from plan years for which open enrollment ended before Feb. 1, 2020, to draw down those balances for dependent care expenses of a child who "aged out" (attained age 13) in that plan year or the following plan year.

  Lockton comment: In essence, the limiting age for the child becomes age 14 if the child turned age 13 in the 2020 plan year or, if the employee had a leftover balance in the dependent care FSA at the end of that year, turned age 13 in the following year. In that latter case, however, this increase in the limiting age only applies to the leftover balance in the dependent care FSA at the end of the 2020 plan year.

- Health FSA participants who lost eligibility to participate in the FSA (i.e., due to termination of employment) in the 2020 calendar year or who lose eligibility this year can be offered, on a non-COBRA basis, access to their FSA account balance for post-termination health expenses.

  Lockton comment: We don't see a compelling reason to allow this. The rule requires an interaction with the COBRA scheme that seems more trouble than it's worth.

- For employers maintaining general purpose (non-health savings account (HSA) compatible) health FSAs and HSA-compatible high-deductible health plans (HDHPs), the IRS offers a number of options to help preserve HSA eligibility for employees who might otherwise lose that eligibility during a carryover period or extended grace period adopted by the employer.

What's an employer to do?

How does an employer want to think about these potential accommodations? First, of course, the employer should determine how many employees might benefit from one or more of these accommodations, and to what extent. For example, how many employees actually had FSA residual balances at the end of the 2020 plan

year, how large were the balances, and were they so large that the employer should consider adding or extending grace or carryover periods?

Keep in mind that the accommodations described above are complicated in some respects and will ultimately require a plan amendment. It's also important to confirm that the FSA administrator will be able to handle any accommodations the employer decides to allow.

12-month grace period or 12-month carryover … what's the difference?

If an employer is inclined to take advantage of the new carryover or grace period accommodations, which should it choose: a 12-month grace period or a 12-month carryover?

Pre-CAA, IRS rules allowed for a 2½-month grace period for both health FSAs and dependent care FSAs (meaning employees had 2½ months after the end of the plan year – up to March 15, for calendar year plans – to incur expenses to draw down prior year-end balances.) Health FSAs, but not dependent care FSAs, could allow participants to carry over up to $550 from one year to the entire next plan year. An FSA could not offer both a grace period and a carryover.

The CAA's accommodations blur the lines between a grace period and carryover, as the law allows unlimited carryovers (more than just $550) and up to 12-month grace periods. So, is an employer better off with a grace period or a carryover provision, and does it really make any difference for leftover balances from the 2020 and 2021 FSA plan years?

We think the answer is no, it doesn't make a difference, unless the employer wants to take advantage of special rules that allow terminated health FSA participants to draw down balances by incurring post-termination claims on a non-COBRA basis, something we don't encourage employers to do (that accommodation, by the way, is only available to health FSAs with grace periods, not carryovers).

So, employers will want to ask themselves the following questions:

- The main goal of the CAA's accommodations is to allow employees, in some way, shape or form – but without undue burden on the employer – to use up residual FSA balances from the 2020 and 2021 plan years. The employer will likely want to consider whether these balances are (or, for 2021, likely to be) larger than normal due to the COVID-19 pandemic. If they're not, are employees really worse off if the employer doesn't choose to take on the administrative hassles related to the accommodations?

- If the employer is inclined to implement some of these accommodations, the ones it implements should be consistent with the employer's goals. For example, if employees assumed their 2020 plan year-end balances were going to be forfeited and therefore the employees made large elections for the 2021 plan year, the employer might want to implement an extended grace period or an uncapped carryover and then allow FSA enrollees to *reduce*, but not *increase*, their 2021 elections.

- Does the ***health FSA*** currently have a grace period or carryover? If so, the employer could extend the grace period to a period of up to 12 months or remove the dollar cap from the carryover. If the FSA has neither a grace period nor carryover feature, the employer may add one of up to 12 months. In either case the amendment, if it relates to 2020 residual year-end balances, should be adopted by the end of the plan year ending in 2021.

- Does the ***dependent care FSA*** currently offer a grace period? If so, the employer may extend it to up to 12 months. If it doesn't, the employer may add a grace period of up to 12 months, or a carryover feature of up to 12 months. In either case the amendment, if it relates to 2020 residual year-end balances, should be adopted by the end of the plan year ending in 2021.

- As noted above, it's worth considering how many employees had FSA balances at the end of the 2020 plan year. To what extent do the leftover balances differ between the health FSA and dependent care FSA? If the leftover dependent care FSA balances dwarf the health FSA balances, the employer might choose, for example, to extend the dependent care FSA grace period or add a carryover, but not do so for the health FSA.

- Does the employer wish to add a special non-COBRA coverage continuation provision to the health FSA to allow employees to draw down balances, post-termination (we don't recommend this)? If so, the plan needs a grace period and must be amended to reflect the non-COBRA coverage continuation rule.

- If employees can enroll in an HSA-compatible HDHP, realize that a grace period for, or a carryover from, a general purpose FSA will be disqualifying coverage for purposes of the HSA, for the duration of the grace period or carryover window. The plan can offer workarounds, such as:
    - Automatically treating the leftover amount as available only under a limited purpose (HSA-compatible) FSA
    - Allowing the employee to waive any leftover balance
    - Limiting the grace period or carryover window to less than 12 months (thus, allowing the employee to contribute the full, annual HSA contribution under the rule allowing them to do so if they are eligible to make HSA contributions on Dec. 1).

The how and when

As noted above, the plan amendment implementing these accommodations should be adopted, in the case of calendar year cafeteria plans and FSAs where the amendment relates to the plan year ending in 2020, by the end of this year (if the only amendment the employer is making relates to the plan year ending in 2020, however, a calendar year plan's amendment could wait until Dec. 31, 2022). While that Dec. 31, 2021 amendment deadline is earlier than the deadline the CAA implied, it lines up with the amendment deadline for cafeteria plan accommodations permitted by the IRS in 2020, under its guidance issued last summer. Thus, an employer that implemented at least some of those 2020 accommodations and is prepared to implement at least some of the CAA's accommodations will reflect those changes in a comprehensive amendment adopted by Dec. 31, 2021.

> **Lockton comment:** Lockton will offer a model amendment for these purposes but will not issue it until later in the year in the event the IRS offers up additional accommodations over the coming weeks and months.

Employers should weigh, as they decide whether to implement these accommodations and to what extent, any administrative challenges the accommodations will pose to the employer's payroll and benefits administration system, and the employer's FSA vendor.

A few odds and ends

One of the issues left unaddressed by the CAA was whether, if an employer adopted a carryover feature for its dependent care FSA, and benefits received by the employee in the carryover year exceed the nontaxable

annual limit on dependent care benefits (typically, $5,000), the employee is taxed on the excess. Although there is a cryptic and ambiguous paragraph in the IRS notice suggesting the $5,000 limit on nontaxable benefits doesn't apply, we think the better answer is that the excess will be taxable. Fortunately, the IRS does not impose a tax withholding obligation on the employer for amounts over $5,000, but the agency will get its money when the employee files his federal tax return.

> **Lockton comment:** Under current law and under the recent IRS notice, the employer is only required to report on the employee's W-2 the dependent care benefits *elected* by the employee for the tax year (thus, the employer is not required to report, for a given year, any residual amount carried forward into that year under a grace period or carryover).
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> But when the employee completes IRS Form 2441 for that tax year, the employee will report the amount of prior year residual dollars spent in the FSA grace period (in addition to current year benefits received). If the total benefits received by the employee from the FSA for the year exceed the nontaxable limit, the employee is taxed on the excess. Nothing in the IRS notice suggests Form 2441 will be handled any differently for the 2021 and 2022 years; the notice indicates that dependent care *carryover* amounts (remember that to this point dependent care FSAs have not been permitted to have a carryover feature) spent in 2021 and 2022 will be handled, on Form 2441, the way benefits paid during a grace period are handled under current rules.

As is the case under current law, health FSA benefits made available to an employee in the current plan year under a grace period or carryover feature don't count against the employee's health FSA maximum contribution for the current year ($2,750 for 2021).

The recent IRS notice also makes clear – for those interested in nondiscrimination testing – that the accommodations related to grace periods and carryovers, and the increase in the dependent care FSA limiting age from 13 to 14, are not taken into account in cafeteria plan or dependent care FSA nondiscrimination testing.

Last spring's Coronavirus Response and Relief Supplemental Appropriations Act of 2021 (CARES) allowed health FSAs, HSAs and health reimbursement arrangements (HRAs) to reimburse over-the-counter medications and menstrual products on a tax-free basis to employees and dependents. This change in the law applied to such expenses incurred after 2019. The recent IRS notice provides that health FSAs and HRAs may be amended retroactively to permit this tax-free treatment.

Expiry

It's important to note that these accommodations expire after the 2022 plan year. That is:

- If a health or dependent care FSA utilizes an up-to-12-month grace period in 2021 and 2022, that grace period reverts to 2½ months following the end of the 2022 plan year.

- If a health FSA utilizes an unlimited (in amount) carryover from the 2020 and 2021 plan years (into 2021 and 2022), the carryover from the 2022 plan year will be limited in amount ($550 or an inflation-adjusted amount).

- If a dependent care FSA utilizes a carryover from the 2020 and 2021 plan years (into the 2021 and 2022 years), the carryover cannot apply with respect to 2022 year-end balances (it cannot extend into the 2023 plan year).

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