Compliance Services

LOCKTON

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Appendix B: Details of the FSA accommodations

Under the CAA, employers have the opportunity – if they wish to take it – to provide significant accommodations to employees on the verge of forfeiting FSA balances because they couldn't use up dependent care FSA dollars due to school and day care closures, or couldn't use up healthcare FSA dollars because doctors and hospitalized minimized non-emergency in-person care, like outpatient surgeries. Congress did not authorize cash refunds of year-end FSA balances, but did the next best thing.

Saving grace

Under the CAA, employers whose healthcare and/or dependent care FSAs have a 2.5-month grace period can extend the grace period (over which residual balances from the FSA plan year ending in 2020 may be spent) from March 15, 2021, all the way to Dec. 31, 2021, and may do the same for 2022, with respect to 2021 residual balances.

> **Lockton comment:** What if the employer's FSA program did not have a grace period in place by the end of 2020? May the employer install one *now*, to take advantage of this accommodation calling for a 12-month grace period?
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> There are open questions about the ability to install a new *grace period* in 2021 and apply it to 2020 year-end residual balances. The CAA alludes to "extending" a grace period, perhaps implying that the grace period needed to be in place by the end of the year to which it relates (the IRS's general rule is that a grace period must be installed prior to the end of the year to which it will relate).
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> But it's largely a moot point, for this reason: We think the employer can declare, even in 2021, a 12-month *carryover* window to deal with 2020 year-end residual balances, and get to the same result, as a practical matter (in fact, for employers with health savings account (HSA) programs, FSA carryovers are preferable to grace periods because carryovers allow greater flexibility to avoid disqualifying employees from making HSA contributions).
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> See the carryover and HSA-related discussions below. And as noted further below, the deadline to retroactively amend the cafeteria plan to add such a carryover window is many months into the future.

Carry on

Employers without a grace period under their healthcare FSA might instead be utilizing a carryover feature. A healthcare FSA carryover feature allows a healthcare FSA participant the opportunity to carry over up to $550 in residual, prior year-end balances to the entire new plan year. Under the law prior to the CAA, dependent care FSAs could not utilize a carryover feature.

Under the new legislation, an employer with healthcare or dependent care FSAs with plan years ending in 2020 may permit participants to carry over "any unused benefits or contributions remaining in any such flexible spending arrangement from such plan year to the plan year ending in 2021," and may do the same, through the 2022 plan year, for any unused benefits or contributions remaining in the FSA at the end of the plan year ending in 2021.

> **Lockton comment:** If an employer did not have a carryover rule in place by the end of 2020, may it add one in 2021 and have it relate to 2020 year-end residual balances?
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> We believe so. While the IRS's general rule is that a new carryover rule, like a new grace period rule, must be adopted before the end of the FSA plan year to which it will relate, the CAA's language regarding carryovers seems less restrictive than the language regarding grace periods. While the language regarding grace periods refers to extending a grace period (implying one needed to already be in place), the language regarding carryovers simply says employers may permit participants to carry over their 2020 balances into 2021 (and 2021 balances into 2022), as long as the plan is ultimately amended to allow for the carryover. See the discussion below regarding the substantially deferred deadline for making that amendment.

Does the unlimited carryover affect the maximum benefit an FSA participant may elect for 2021 or 2022? It does not appear so, at least with respect to healthcare FSAs. Even prior to the CAA, the carryover amount from the prior year did not affect the maximum contribution a healthcare FSA participant could elect for the current year.

> **Lockton comment:** For dependent care FSAs the answer might be different. The Tax Code caps at $5,000 annually the tax-free dependent care *benefits* joint filers may receive. The CAA does not increase that limit. So it seems a joint-filing employee who elected $5,000 in dependent care benefits for 2021 and carries over $2,000 into that year would have $7,000 in the dependent care FSA for 2021, but would be limited to $5,000 in *tax-free* benefits for the year. Any dependent care reimbursements from the FSA in excess of $5,000 would be taxable, unless the IRS rules that the carried over funds can be paid out in tax free reimbursements, even if the total benefits for the year exceed $5,000.
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> But even if the IRS doesn't go that far, even if in the example above the employee can receive $2,000 in *taxable* benefits, that's not a bad thing. It effectively works as a sort of taxable refund of the residual balance that would otherwise have been forfeited.

New elections

Under the CAA, employers may also permit employees who made 2021 health and dependent care FSA elections during their recent open enrollment windows to prospectively modify those elections without the usual "change in status" event. For example, it might make sense for an employee to substantially scale back an FSA election for 2021 if the employer will now give the employee the entire 2021 plan year to use up the employee's 2020 residual year-end balances.

Terminations and continued coverage

In addition, employers may permit their healthcare FSA to allow employees who terminated participation in 2020 (because of layoff or furlough, for example), or who do so in 2021, to continue to incur and submit claims, apparently, on a non-COBRA basis, through the end of the plan year in which the termination of participation occurred, and the end of any grace period related to that year, even an extended grace period per the CAA.

> **Lockton comment:** Existing rules already allow dependent care FSAs to do this, at the employer's option.

Sweet child of mine

Finally, the legislation includes a special rule allowing continued tax-free dependent care FSA reimbursements for care of children who recently turned age 13.

> **Lockton comment:** Under the law prior to the CAA, tax-free dependent care benefits are not available for non-disabled children once they attain age 13.

If the employee was enrolled in a dependent care FSA for a plan year beginning before Jan. 31, 2020, and the child attained age 13 during that plan year (or, if the employee has a residual balance in the FSA at the end of the plan year, the child attained age 13 in the following plan year), the limiting age for the child is adjusted to age 14.

Turning back the clock

These are permissive, not required, changes for employers to make. While we expect most employers will adopt these changes, they are not mandatory.

Employers wishing to make these accommodations have plenty of time to amend their plans retroactively to allow for these changes. Employers may adopt these changes up to the last day of the first calendar year beginning after the end of the plan year in which the amendment is effective. So, for example, an amendment effective beginning Jan. 1, 2021, for a calendar year FSA would need to be adopted by the last day of 2022. The employer would, in the meantime, need to operate the plan in accordance with the terms of the amendment it makes later.

> **Lockton comment:** For employers that wish to adopt the changes (in whole or in part) we will add these accommodations as optional amendments to our model cafeteria plan amendment we're holding until next year, relating to the accommodations the IRS authorized last summer. The IRS allowed employers until the end of the 2021 plan year to adopt any amendment reflecting last summer's accommodations.

Beware the HSA thorns

As many employers know, coverage as of the first day of a month under a general purpose healthcare FSA disqualifies the participant from making health savings account (HSA) contributions for that month. Where a general purpose healthcare FSA has a grace period (say, from each Jan. 1 to March 15 following the close of a calendar year plan year), and an employee begins the grace period with even so much as a penny as a residual

balance from the prior plan year, the employee is disqualified from making HSA contributions for January, February and March.

> **Lockton comment:** A similar rule applies to carryovers; an employee who carries over even a penny from one general purpose healthcare FSA plan year to the following plan year is disqualified from making HSA contributions for that entire following year.

Employers wishing to expand their healthcare FSA's grace period from 2.5 months to as many as 12 months, for either or both of 2020 and 2021 year-end residual balances, should be aware that employees with a residual balance available during the grace period will not be eligible to make HSA contributions for any month in which even a portion of the grace period falls. One largely unsatisfactory way around this result is for the employer to amend the healthcare FSA to make it a limited purpose, HSA-compatible FSA for *all participants*. A limited purpose FSA is one that reimburses only dental, vision and preventive care.

> **Lockton comment:** Carryovers, however, provide the employer with more flexibility in helping employees avoid disqualification from making HSA contributions. An employer offering a carryover feature and both general purpose and limited purpose FSAs can amend its cafeteria plan to allow employees to individually elect whether to have their carried-over amounts treated as limited purpose funds, or to *unilaterally* treat the carried over amounts as available only under the limited purpose FSA.

How will all this work?

FSA vendors are still reviewing the rules to determine how best they can help their customers. Benefits administration vendors and the systems they sold to employers will also have a role to play here, for employers that want to take advantage of these accommodations.

Additionally, we suspect the IRS will need to issue clarifying guidance on many key points. For example, can an employer allow employees to prospectively increase their elections or only decrease them? How does the IRS feel about an employer installing in 2021 a grace period or carryover feature that relates to 2020? How does the rule allowing for post-termination participation in the FSA interact with COBRA rights?

What will Lockton provide?

As noted above, Lockton will make available a model cafeteria plan/FSA amendment with which employers may adopt any changes to their cafeteria plans, including FSAs, authorized last summer by the IRS or by the CAA. We will also provide, as part of our webcast handout materials, a model employee communication piece that employers may use to describe these changes to their employees.

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