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Employee Benefits and Executive Compensation

ACT NOW ADVISORY

# Stimulus Bill Includes Temporary Special Relief for Flexible Spending Accounts

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On December 27, 2020, President Trump signed the over $2 trillion omnibus appropriations and COVID-19 relief package, the Consolidated Appropriations Act, 2021 ("Act"). The Act includes provisions funding the government through September 30, 2021, and a $900 billion COVID-19 relief and stimulus package.

Among the sections of the Act is Division EE, the Taxpayer Certainty and Disaster Tax Relief Act of 2020, which includes, under Title II, Section 214, provisions for temporary special relief and significant additional flexibility for both types of flexible spending accounts ("FSAs")—health FSAs and dependent care FSAs. Specifically, the Act provides the following:

- **Any Unused Funds from 2020-2021 and 2021-2022 Plan Years May Be Carried Over.** Under prior law, carryovers were limited to health FSAs only and subject to Internal Revenue Service ("IRS") limits ($550 for carryovers from the 2020 plan year to the 2021 plan year). The Act permits employers to amend both health FSAs and dependent care FSAs to permit carryovers of all unused balances from plan years ending in 2020 and 2021 into the subsequent plan years ending in 2021 and 2022, respectively.

- **Grace Periods for 2020 and 2021 Plan Years May Be Extended.** Under prior law, grace periods to incur claims for health FSAs and dependent care FSAs were limited to a maximum of 2½ months. The Act permits an employer to amend its health FSAs and dependent care FSAs to extend the grace period to up to 12 months after the plan years ending in 2020 and 2021.

- **Terminated Employees May Spend Down Their Health FSAs.** Under prior law, only dependent care FSAs were permitted to include a "spend down" feature whereby terminated employees may continue to incur expenses through the end of the plan year (including any grace period) in which they terminated employment. Under the Act, an employer may amend its health FSA to permit employees who terminate employment midyear during calendar year 2020 or 2021 to continue to incur reimbursable health claims for the remainder of the plan year in which their employment ends (as well as any grace period).

Prior to the Act, terminated employees with underspent health FSAs generally could continue to receive reimbursement from the FSA by electing Consolidated Omnibus Budget Reconciliation Act ("COBRA") continuation coverage. Employers that have adopted this spend-down provision should advise their COBRA administrators and coordinate regarding appropriate notification to departing employees, because, arguably, the individuals would no longer have a loss of health FSA coverage triggering a COBRA election. In addition, employers should advise terminated employees that they would be ineligible to make or receive health savings account ("HSA") contributions in connection with another employer-sponsored high-deductible health plan ("HDHP") with an HSA if the terminated employees continue to be covered under a general purpose health FSA (i.e., one that covers all eligible medical, dental, vision, and pharmacy expenses).

- **Dependent Care FSAs May Reimburse Expenses for Children Who Reached Age 13**. Under prior law, an employee's child generally ceases to be a qualifying individual, eligible to have expenses reimbursed under the dependent care FSA, upon the child's 13th birthday. Under the Act, employees who have unused funds for children who reached age 13 during the last dependent care FSA plan year for which the open enrollment period was on or before January 31, 2020, may continue to treat the child as eligible up to age 14 for the remainder of such plan year and, to the extent a balance remains at the end of the plan year, the following plan year until the child turns age 14 (but only with respect to the unused amount).

- **Prospective Health FSA and Dependent Care FSA Election Changes May Be Made for Any Reason for Plan Years Ending in 2021.** Under prior law, health FSA and dependent care FSA elections could not be changed midyear absent a permissible election change event. In response to COVID-19, the IRS issued guidance in IRS Notice 2020-29, which allowed employers to amend their cafeteria plans to make election changes in 2020. The Act extends this flexibility another year and allows employers to amend their cafeteria plans to permit employees to prospectively change their health FSA or dependent care FSA election during plan years ending in 2021 without experiencing a permitted change in status election event.

  To ease the administrative burden of implementing multiple changes, employers may consider limiting the number of election changes that participants can make in the year. In addition, to minimize financial exposure as a result of experience losses under the health FSA because of the uniform coverage rule, employers may limit new annual participant election amounts to the greater of the amount contributed in 2021 and the amount of reimbursements received in 2021 as of the date of the election.

*All of the above provisions are optional*.

## Plan Amendments May Be Retroactive

Employers wishing to offer any of these optional FSA provisions must amend their cafeteria plan to incorporate the changes. The deadline for employers to adopt the amendments is the last day of the first calendar year beginning after the end of the plan year in which the amendment is effective (so long as the plan is operated consistent with the amendment during the retroactive period). For example, employers must adopt amendments that are effective as of January 1, 2021, by December 31, 2022.

## Special Considerations for Employers with HDHP/HSAs

For health FSAs, the grace period and carryover options appear to be identical. However, these options can have different impacts on an employee's ability to contribute to an HSA.

A general purpose health FSA is considered "disqualifying" coverage for HSA purposes because the FSA provides first dollar coverage before the deductible is met. Employers that have participants who switched from a non-HDHP plan to a HDHP/HSA plan for the 2021 plan year may want to choose the carryover (rather than the extended grace period) because an employer can design the plan so that those monies can be ***automatically*** converted to a limited purpose FSA (i.e., one that only covers eligible dental and vision expenses) for these participants to avoid HSA disruption. Under existing guidance, other options to avoid HSA disruption as a result of a carryover feature are to allow a participant to choose to convert the carryover funds to a limited purpose carryover or to allow the participant to waive and forfeit the carryover amount.

Typically, when an employer adopts a grace period that ends on March 15, employees switching to the HDHP/HSA are ineligible to make or receive HSA contributions until April 1, unless, in accordance with IRS guidance, participants "***zero out" their balances*** by December 31 of the prior plan year, i.e., all expenses have been incurred and paid by that date. Accordingly, employees who still had balances in their 2020 general purpose health care FSAs as of December 31, 2020, will ***not*** be HSA eligible for the ***entire*** 2021 plan year, unless:

1. They drop their general purpose FSA, or

2. The plan is designed to convert general purpose FSA balances to limited purpose FSAs during the grace period. Generally, however, this is not a favored option because, under IRS guidance, the change must apply to ***all*** employees, not just those switching to the HDHP and would therefore restrict all other employees' health FSA reimbursements to limited purpose FSA expenses.

## Special Considerations for Dependent Care FSAs

The Act does ***not*** change the statutory annual contribution limits. Therefore, if an employer adopts the grace period or carryover feature, participants who have elected the maximum $5,000 ($2,500 if married filing separately) dependent care FSA benefit for 2021 will need to adjust their election amount down, if they wish to have their entire benefit remain tax-free. Any amount reimbursed in 2021 in excess of the statutory limit will be

taxable. Employers that adopt the grace period or carryover feature should explain to participants how the carryover or grace period amounts are counted toward the dependent care FSA statutory limits and that they will have taxable income if their dependent care FSA reimbursements exceed the maximum because of the carryover or grace period.

**Other Considerations**

In addition, the Act does ***not*** change the other FSA requirements and, in particular, nondiscrimination testing. When considering adoption of these optional provisions, employers should consider the impact of such a design change on any applicable testing.

**What Employers Should Do Now**

Many employers have been fielding questions from employees with unused balances in their health FSAs and dependent care FSAs as a result of the pandemic. While the Act and applicable IRS guidance do not allow an employer to "cash out" unused balances, they do provide welcome relief and significant flexibility to minimize forfeitures related to the 2020 and 2021 plan years.

Employers should:

- consider whether to adopt any of the Act's optional provisions (taking into account, among other things, that they may expect fewer experience gains to offset experience losses if this relief is adopted);
- work with their legal counsel to ensure that any intended design is consistent and compliant with their other offerings and meets any necessary nondiscrimination testing;
- work with their vendors to ensure that the vendors can administer the desired changes;
- communicate any changes to participants;
- keep a record of any changes (and operate plans consistently) so that plans can be timely amended retroactively, and then amend the plans within applicable deadlines; and
- monitor IRS guidance for any implementing clarifications.

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