

IRS Guidance on COVID-Related Cafeteria Plan Flexibility

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This week, the IRS released guidance further clarifying items in the recently passed Consolidated Appropriations Act of 2021 (CAA) permitting flexibility for health flexible spending arrangements (FSAs), dependent care account plans (DCAPs) and cafeteria plan election change rules. None of these changes are required. Employers have the option to implement some or all of the changes, or employers could choose not to change their plans at all. For employers who are willing to allow some additional flexibility, IRS Notice 2021-15 provides further details on exactly what is permitted and how it may impact things such as annual contribution limits, HSA-eligibility, COBRA continuation, and nondiscrimination rules. The notice also added some additional election change flexibility around health coverage similar to what was available in 2020 under Notice 2020-29.

IRS Notice 2021-15: <https://www.irs.gov/pub/irs-drop/n-21-15.pdf>

Health FSA & DCAP Carryovers OR Extended Grace Periods

For plan years ending in 2020 or 2021, an employer may choose to adopt the following:

- Health FSA:
 - A carryover of any unused health FSA balance to the next plan year (rather than being limited to \$550); OR
 - A grace period of up to 12 months (rather than 2 ½ months) to continue incurring expenses toward the unused health FSA balance.
- DCAP:
 - A carryover of any unused DCAP balance to the next plan year (for plan years not covered by this guidance a carryover is not permitted for a DCAP); OR
 - A grace period of up to 12 months (rather than 2 ½ months) to continue incurring expenses toward the unused DCAP balance.

A health FSA or DCAP may offer a carryover or an extended grace period, but not both. While both options may offer the ability for participants to use the prior year's unused balance into the next plan year, a grace period will make the unused balance available to those who are no longer participants, while a carryover is generally only available to those who are still participating in the subsequent plan year.

The expanded carryover or extended grace period is allowed for limited-purpose, post-deductible, and general-purpose health FSAs. For health FSAs and DCAPs, the carryover or grace period may be offered regardless of whether the plan is currently designed to offer a carryover, grace period, or neither one. So, for example, a health FSA that currently offers a carryover could be amended to instead offer an extended grace period, and a DCAP that currently offers a 2 ½ month grace period could be amended to instead offer a carryover.

An employer adopting either the expanded carryover or extended grace period has some flexibility with the design. For instance, the employer could limit the amount of the carryover, or offer a grace period of less than 12 months. The employer could also limit the ability to carryover unused amounts to those who elect to contribute toward the next plan year.

Effect on Election Limits

Unused amounts carried over from prior years or available during an extended grace period are not taken into account for purposes of determining the annual contribution limits. Therefore, for the 2021 plan year, participants may elect to contribute up to \$2,750 into a health FSA even if they have a carryover or extended grace period available from unused amounts contributed during the 2020 plan year. Similarly, participants may contribute up to \$5,000 to a DCAP in addition to any carryover or extended grace period amounts that may be available from the previous plan year. In addition, unused amounts from a plan year ending in 2020 that are not used during 2021 could be made available into the 2022 plan year.

Impact on HSA Eligibility

When considering whether and how to adopt a carryover or extended grace period for the health FSA, the employer should consider HSA-eligibility. Individuals who are eligible for reimbursement from a general-purpose health FSA are not eligible to contribute to an HSA. For participants with a health FSA balance at the end of the plan year, a carryover or extended grace period could extend HSA-ineligibility into the next plan year.

- Health FSA with a Carryover: If the participant has an unused year-end balance, the individual is ineligible for HSA contributions for the entire next health FSA plan year (because the carryover can be used any time during the year), unless the employer allows participants to waive the carryover or make the carryover limited-purpose. Unlike the grace period, the employer is allowed to design the carryover to be converted to limited-purpose for those who enroll in an HDHP and remain general-purpose for the other participants.
- Health FSA with a Grace Period: If the participant has an unused year-end balance, the grace period extends the participant's period of HSA ineligibility through the end of the grace period (up to 12 months), unless the employer makes the grace period limited-purpose for all participants (i.e., participants could not be given a choice between a limited-purpose or general-purpose grace period).

Finally, amounts available via a carryover or extended grace period are disregarded in determining the COBRA premium for a health FSA, and can be ignored for purposes of §125 and §129 discrimination testing.

Health FSA Post Termination Reimbursements

For employees who lose eligibility for a health FSA due to a reduction in hours or termination of employment during calendar year 2020 or 2021, the health FSA can continue to reimburse qualifying medical expenses incurred through the end of the plan year rather than being limited to reimbursement of expenses incurred prior to the loss of eligibility. Employers considering this option will generally want to limit the reimbursement to contributions made prior to the loss of eligibility rather than allowing access to the full amount elected for the plan year. Adopting this flexibility does not relieve the employer of having to offer the option to elect COBRA continuation through the end of the health FSA plan year for an underspent account.

Special Rule for DCAP Participants with Dependents Who Age Out

Typically, a DCAP can only be used to reimburse expenses related to dependents who have not attained the age of 13. The legislation contains a temporary rule that allows a plan to reimburse expenses for dependents who have not attained age 14 under the following circumstances:

- The employee elected to participate in a DCAP plan that had a regular enrollment period on or before January 31, 2020; and
- A dependent child reached age 13 during that plan year, or the next plan year if there are unused expenses that are carried over.

Example: A DCAP with a plan year of January 1 – December 31, 2020 had an open enrollment period that ended November 30, 2019 (before January 31, 2020). Employee elected \$5,000 for the 2020 plan year, and the employee's dependent child turned 13 in September 2020. Employee may use the \$5,000 for any qualifying daycare expenses for the child incurred during 2020; and any balance remaining at the end of the 2020 plan year may be used to reimburse qualifying expenses for the 13-year-old until September 2021 (when the child turns 14).

Election Changes

For any plan years ending during 2021, the employer may permit participants to make the following mid-year election changes, on a prospective basis, even without a recognized change in status event:

- Health coverage (e.g. medical, dental or vision)
 - Elect health coverage if the employee previously waived;
 - Revoke an existing election health coverage and make a new election to enroll in different health coverage sponsored by the same employer, or move from single to family coverage; or
 - Revoke an existing election for health coverage, provided that the employee attests in writing that the employee is enrolled, or immediately will enroll, in other health coverage. An employee requesting to drop medical coverage may not revoke the election by attesting to enrollment in coverage solely for dental or vision benefits.

- Health FSA or DCAP - Employees may begin participation, end participation, or increase or decrease contributions.

NOTE: The CAA provided flexibility to make prospective health FSA or DCAP election changes. The ability to allow participants to make election changes to health coverage is new under this IRS guidance (although it was permitted during 2020 under IRS Notice 2020-29).

An employer choosing to adopt some flexibility for election changes is permitted to limit the number of election changes and the time frame for making election changes, but any permitted election must be allowed only on a prospective basis. Employers may want to allow employees to change elections from a higher cost option to a lower cost plan, but not allow new enrollments for employees who previously waived coverage (unless required by existing HIPAA special enrollment requirements). For health FSAs and DCAPs:

- Employers might want to limit health FSA and DCAP election changes for participants based on how much has been reimbursed at the time of the desired election change.
- If participants choose to discontinue participating in a health FSA or DCAP, the employer may choose to allow unused amounts to be available through the end of the plan year, or the employer could choose to require that any unused amounts be forfeited.
- If employees who were eligible and waived at the beginning of the plan year enroll in a health FSA or DCAP mid-plan year, the employer may choose to allow reimbursement of qualifying expenses incurred back to the beginning of the plan year.
- Normally, enrolling in an HDHP is not an event that on its own would permit a mid-year election change for a health FSA. However, if the employer chooses to be flexible with election changes, participants could terminate participation in the health FSA and begin contributing to an HSA.
- The ability to make election changes does not change that the plan cannot pay out unused amounts in cash.

Plan Amendments

Plans may be amended retroactively to implement any or all of these provisions so long as the employer operates in accordance with the terms of the amendment and informs all employees eligible to participate in the cafeteria plan of the changes to the plan. The plan amendment must be made 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 example, for changes made to plan with a plan year ending 12/31/2020, the amendment must be made by 12/31/2021; and an amendment for a 2020 non-calendar year plan, must be adopted by December 31, 2022. Employers may adopt a plan amendment by indicating that the amendment supersedes normal operations for the applicable plan years to allow the plan to revert to previous practice (e.g. a carryover up to \$550 or a 2 ½ month grace period) without further amendment.

Summary

The changes available via the CAA and further clarified in IRS Notice 2021-15 are completely optional, and employers choosing to adopt some of the permitted changes have significant flexibility to place limits on such changes. For example, employers may want to allow some of the changes for its plan year ending during 2020, but not for the plan year ending in 2021. The changes will be welcomed by employees with significant year-end balances or those needing to make mid-year election changes, but employers will need to weigh this against the administrative and communication challenges that may accompany such changes. Employers will also need to closely coordinate with the vendors they use for plan administration.

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