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Appropriations Act provides needed health and dependent care FSA relief

Due to the ongoing pandemic, some employees have unused funds remaining in their health care and dependent care FSAs from 2020 that may be subject to forfeiture. The Consolidated Appropriations Act, 2021, signed by the president on December 27, provides relief to those employees by giving them additional time to use those FSA funds. The Act also includes other FSA relief. The relief provided is optional and employers will need to decide what actions, if any, they want to take.

Background

Section 125 of the Internal Revenue Code, which governs cafeteria plans, authorizes giving employees a choice between receiving cash or certain nontaxable qualified benefits and to pay for those benefits on a pretax basis. Qualified benefits include health coverage, health flexible spending accounts (FSAs), and dependent care FSAs.

Cafeteria plan elections generally must be irrevocable for the entire plan year. However, regulations under Section 125 authorize, but generally do not require, a cafeteria plan to permit midyear election changes under certain specified circumstances (e.g., due to certain change in status events). Permitted election changes must be set out in the cafeteria plan document and communicated to employees.

After the start of the COVID-19 pandemic, some employees wanted to modify their benefit elections to reflect changes in their circumstances or benefit needs; however, these employees had not experienced an event that would permit an election change under Section 125 rules. In May 2020, the IRS issued guidance that significantly increased employer flexibility in allowing midyear election changes for cafeteria plans, health FSAs, and dependent care FSAs. The guidance also permitted amounts remaining in an employee's health FSA or dependent care FSA at the end of the plan year

Volume 44

Issue 01

January 6, 2021

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or grace period ending in 2020 to be used to reimburse eligible expenses incurred through December 31, 2020. (See our [May 14, 2020 FYI Alert](#).)

However, many employees were not able to use all the funds in their FSA before the end of 2020. Since most employer health and dependent care FSA plans operate on a calendar year basis, employees faced forfeiting unused funds on December 31, 2020 under the “use-it-or-lose-it” rule.

The [Consolidated Appropriations Act, 2021](#) (CAA), signed by the president on December 27, includes provisions that address this issue as well as other important issues for health and dependent care FSAs.

CAA provisions affecting health and dependent care FSAs

The CAA enables participants in health and dependent care FSAs to avoid forfeitures of their 2020 and 2021 account balances. None of the relief is mandated — employers may decide which relief provisions, if any, to adopt. Plan amendments are required to institute these changes.

- **FSA carryovers.** For plan years ending in 2020 or 2021, a plan may permit participants in health FSAs and dependent care FSAs to carry over unused amounts to the subsequent plan year, regardless of amount. (Under existing guidance, only health FSA balances may be carried over, and the maximum carryover amount for 2020 balances is \$550.)

Buck comment. As an example, an employee with \$2,000 left in a health FSA from the 2020 plan year may be permitted to carry over that full amount to the 2021 plan year. If the employee had elected to contribute \$2,750 for the 2021 plan year, they would be eligible for reimbursement of \$4,750 in health expenses during the 2021 plan year. However, the employer could permit the employee to reduce their 2021 election. (See below on change in election amounts.)

Can a plan have both a carryover and a grace period?

The new CAA provisions state that rules similar to the current rules for health FSA carryovers will apply. Because those rules prohibit a health FSA from offering both a carryover and a grace period, it appears that a plan may provide for either a carryover or a grace period, but not both.

Similarly, an employee with \$2,000 left in a dependent care FSA for the 2020 plan year may be permitted to carry over that full amount to the 2021 plan year. Because an employee can generally only exclude \$5,000 in dependent care benefits received during a calendar year, if they had previously elected \$5,000 for the 2021 plan year, they may want to reduce their 2021 election to \$3,000 so that the total benefits in 2021 will be capped at \$5,000. (See below on change in election amounts.) However, if an employee receives more than \$5,000 from the dependent care FSA during a calendar year, the employer may be required to withhold taxes on the excess payments. Employers should consult their advisors on this issue.

- **FSA grace periods.** For plan years ending in 2020 or 2021, the grace period can be extended to up to 12 months after the end of the plan year.
- **Changes in election amounts.** For plan years ending in 2021, a cafeteria plan may permit employees to make prospective changes in their health and dependent care FSA elections regardless of any change in status.

Impact on HSAs

The addition or extension of a grace period or a carryover for a health FSA can make affected employees ineligible to contribute to an HSA.

Buck comment. While some employers may be hesitant to allow employees to change their 2021 health FSA elections, they should consider allowing employees to reduce their 2021 election to reflect any funds that may now be available from 2020 because of CAA relief.

The CAA also includes provisions specific to only a health FSA or dependent care FSA.

- **Post-termination reimbursements from health FSAs.** Under rules similar to those that apply to dependent care FSAs, a cafeteria plan may permit employees who ceased participation in a health FSA in either calendar year 2020 or 2021 to continue receiving reimbursements from the health FSA through the end of the plan year when participation ended, including any grace period.
- **Children who age out of a dependent care FSA during the pandemic.** For plan years for which the last open enrollment period ended on or before January 31, 2020 (e.g., for plan years beginning on January 1, 2020), the eligibility age for dependent care expenses is raised from 13 to 14. This means that a dependent care FSA is permitted to reimburse expenses associated with the care of a child who turned age 13 during such plan year. In addition, a plan may continue to reimburse the child's eligible expenses incurred during the following plan year from any unused balance remaining at the end of the plan year.

Plan amendments

An employer must amend its cafeteria plan to authorize any of the relief permitted by the CAA. An amendment for changes made for plan years ending in 2020 must be adopted by December 31, 2021. An amendment for changes made for plan years ending in 2021 must be adopted by December 31, 2022. The changes can be made retroactively provided that the cafeteria plan operates in accordance with the amendment and the employer communicates the changes to all eligible employees.

In closing

Since these provisions are optional, employers will need to decide what actions, if any, they will take, communicate those change to employees, and coordinate the administration of the changes.

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