

U.S. COVID-19: RING IN THE NEW YEAR WITH COVID-19 RELIEF FOR HEALTH AND DEPENDENT CARE FLEXIBLE SPENDING ACCOUNTS

Jan 12, 2021

Thanks to the [*Consolidated Appropriations Act, 2021*](#) (the “Act”), employers with health flexible spending accounts (“HFSAs”) and dependent care flexible spending accounts (“DFSAs”) may adopt temporary liberalized rules to help reduce employees’ forfeitures during the pandemic. The Act expands upon some of the prior relief provided under [IRS Notice 2020-29](#) and temporarily relaxes certain standard HFSA and DFSA rules for the 2021 and 2022 Plan Years.

Employers will want to work through the new relief, determine what provisions to adopt, and communicate any changes in short order.

- **Increased Carry-Over Amounts**

- A cafeteria plan may allow for the carry-over of up to 100% of the unused HFSA and DFSA balances at the end of the 2020 and/or 2021 Plan Year(s) to the next Plan Year. Under the standard cafeteria plan rules, carry-overs are limited only to HFSAs.
- Carried over amounts do not reduce the maximum annual HFSA or DFSA benefit amount a participant may elect for a Plan Year.

- **Extended Grace Period for Incurring Claims**

- Generally, a plan may allow a grace period of up to 2 ½ months following the end of a Plan Year during which participants can incur additional expenses to be paid or reimbursed from HFSA and DFSA amounts remaining at the end of the immediately preceding plan year. IRS Notice 2020-29 allowed employers to extend any HFSA and DFSA grace period ending in 2020 to December 31, 2020.
- The Act permits employers to adopt a grace period of up to 12 months for Plan Years ending in 2020 and/or 2021 (e.g., for a calendar year HFSA, the grace period for the 2020 Plan Year can extend through December 31, 2021 instead of ending on March 15, 2021).

- A grace period does not affect the maximum annual HFSA or DFSA benefit amount a participant may elect for a Plan Year.
 - The availability of the *extended* 12-month grace period appears limited to plans that already have a grace period. The general rule for amending a plan to add a grace period is that the amendment must be adopted by the end of the applicable Plan Year for which the grace period will be offered. This would mean that for a calendar year plan, the grace period cannot now be added for the 2020 Plan Year. However, an employer could still take advantage of the extended 12-month grace period for the 2021 Plan Year by amending the plan by the last day of the 2021 Plan Year (December 31, 2021, for calendar year plan years) to add the grace period.
- **Relaxed Mid-Year Election Change Rules for 2021 Plan Year**
- Under IRS Notice 2020-29, employers could allow employees to make prospective mid-year election changes in 2020 to enroll in, drop, increase (within the annual limit) or decrease health plan, HFSA and/or DFSA coverage(s) without requiring the usual change in status event.
 - The Act extends employers' ability to allow participants to make mid-year changes their HFSA and/or DFSA election(s) prospectively for Plan Years ending in 2021 , but not their health plan elections. Note: The current annual contribution limit for HFSA is \$2,750 and the annual contribution limit for DFSAs is \$5,000.
 - Allowing the mid-year election allows participants to adjust their current HFSA and/or DFSA coverage(s) prospectively to take into account amounts that have become available for use under the expanded carry-over rules, or, in the alternative, the extended grace period. A participant also can elect new contribution amounts to account for changes in personal circumstances, which typically is not permitted in the context of HFSA even when a change in status event occurs.
- **Reimbursement of Post-Termination Expenses**
- Under the standard cafeteria plan rules, only health expenses incurred while the HFSA coverage was in effect are eligible for reimbursement. Under the Act, cafeteria plans may allow current and former employees whose participation in the HFSA terminated before the end of the 2020 or 2021 Plan Year to continue to be reimbursed for health expenses incurred through the end of the Plan Year in which their participation in the HFSA ended.

Example: Under the standard rule, if a participant has a \$1,000 credited to his HFSA at the time his coverage ends effective April 1, 2020, the outstanding balance can be used to reimburse only those health care expenses incurred prior to April 1, 2020. However, if the employer adopts the relief available under the Act for former participants, any health care expenses incurred by the former participant from April 1, 2020 through December 31, 2020 would be eligible for reimbursement.

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- Any grace period for incurring additional expenses, including an extended 12-month grace period, will apply to the former HFSA participant.

Example: If the employer above also adopts a 12-month grace period for the Plan Year ending December 31, 2020, any health care expenses incurred by the former participant through December 31, 2021 is eligible for reimbursement from the \$1,000 HFSA balance.

The statute does not limit the relief to participants who cease participation in an HFSA mid-year due to termination of employment, suggesting that if a participant elects to cease contributions in reliance on the temporary relaxed mid-year election rule, he or she could continue to incur reimbursable claims through the end of the plan year. Clarifying IRS guidance on this point would be helpful.

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- Although the Act does not include a corresponding provision for DFSAs, the existing cafeteria plan rules already include a “spend-down” option that allows employees who lose DFSA coverage to use their remaining account balance for dependent care expenses incurred through the end of the Plan Year in which their DFSA coverage ends.

▪ **Special Carry-Forward Rule for DFSAs – Increased Age**

- A dependent child who turned age 13 during a Plan Year with an enrollment period that ended on or before January 31, 2020 may continue to be treated under the DFSA as a qualifying dependent through the last day of the Plan Year. If the participant has unused amounts as of the last day of such Plan Year, the DFSA may reimburse the dependent care expenses incurred during the next Plan Year for the aged-out dependent from the outstanding DFSA balance.

Action Items

Employers should:

1. Determine whether to adopt the temporary liberalized rules described above and if yes, whether to apply the relief to the Plan Year ending in 2020, the Plan Year ending in 2021 or both Plan Years. Note, a flexible spending account cannot include both a carry-over provision and a grace period. Considerations in adopting the temporary rules may include:

- - **Third-Party Administrator Limitations:** Whether there are limitations in what the plan's third-party administrator is able to administer and whether the third-party administrator requires a notice period prior to implementing the changes.
 - **Additional Costs:** Whether changes to the plan, such as increased participation due to a grace period, will affect the administrative costs of the plan due to increases in fees calculated on a per participant basis.
 - **Grace Periods:** If an employee has unused amounts in his or her HFSA at the end of the Plan Year and the HFSA has a grace period, the employee is HSA-ineligible for each month during the grace period unless participation during the grace period is restricted to a limited purpose HFSA. Consequently, the adoption of a 12-month grace period will essentially render the employee with an unused balance in a general purpose HFSA (and any covered spouse) ineligible to make or receive HSA contributions for the entirety of the next Plan Year even if the employee does seek reimbursement of any expenses incurred during the grace period.
 - **Carry-Over Amounts:** If an employee has any amount carried over to a general purpose HFSA, he or she will not be eligible to make or receive HSA contributions for the entire Plan Year. The impact of the carry-over and the extended 12-month grace period on HSA-eligibility seems identical but there is one important distinction; an employer can allow employees to waive any carry-over.
2. Communicate any plan changes to affected current and former HFSA and DFSA participants and eligible employees, and describe the procedures and applicable deadlines relevant to the new rules.
3. Work closely with plan service providers to adopt internal procedures and deadlines to administer any plan changes.
4. Amend their plan to reflect the new provisions no later than the last day of the first calendar year beginning after the end of the Plan Year in which the change is effective.

***Example:** For plan changes that will apply to a 2020 calendar year Plan Year, an amendment must be adopted by December 31, 2021.*

As a reminder, plans must be amended by December 31, 2021 for any adopted relief provided under IRS Notice 2020-29 (e.g., 2020 mid-year election changes and extended grace period through December 31, 2020) and [IRS Notice 2020-33](#) (e.g., indexed 20% increase in the HFSA carry-over maximum, raising the carry-over limit from \$500 to \$550). For additional discussion of IRS Notice 2020-29, see our [Mid-Year 2020 Newsletter](#).

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