

# COMPLIANCE BULLETIN

## Clarifying Guidance for Health FSA and DCAP COVID-19 Relief

On Feb. 18, 2021, the IRS released [Notice 2021-15](#) to clarify the application of temporary special rules for health flexible spending arrangements (FSAs) and dependent care assistance programs (DCAPs) provided under the Consolidated Appropriations Act, 2021 (CAA).

The Notice responds to unanticipated changes in the availability of certain medical and dependent care as a result of COVID-19, as employees are more likely to have unused health FSA or DCAP amounts at the end of 2020 and 2021.

While the Notice also provides additional mid-year election change relief for Section 125 cafeteria plans generally, this Compliance Bulletin highlights the major clarifications and examples regarding the **health FSA and DCAP relief**. It also illustrates how the health FSA and DCAP relief provisions interact with each other, how certain provisions impact eligibility to contribute to an HSA as well as their impact on COBRA continuation coverage.

### Action Steps

- ☑ Employers have **discretion** in adopting some or all of the relief discussed in this Bulletin, and can generally determine the extent to which the relief is permitted and applied.
- ☑ Employers that wish to implement the CAA and the Notice relief for a cafeteria plan with a health FSA or a DCAP **must adopt a plan amendment** to do so. The amendment may be effective retroactively to the beginning of the applicable plan year, so long as certain requirements are satisfied.

### CAA Provisions

The CAA, enacted at the end of 2020, allows employers with health FSAs and DCAPs to:

- ☑ Permit employees to carry over unused amounts from the 2020 and 2021 plan years;
- ☑ Extend the grace period for plan years ending in 2020 and 2021;
- ☑ Adopt a special rule regarding post-termination reimbursements from health FSAs for employees who cease plan participation during 2020 or 2021;
- ☑ Provide a special claims period and carry forward rule where the dependent “aged out” during the pandemic; and
- ☑ Permit mid-year election changes for health FSAs and DCAPs for plan years ending in 2021.



## Carryover Relief

The CAA allows an employer, in its discretion, to provide a carryover of unused amounts remaining in a health FSA or DCAP as of the end of a plan year ending in 2020 or 2021 to the immediately subsequent year. The Notice clarifies that:

- ☑ The carryover is available to plans that currently have a grace period or provide for carryover, as well as plans that currently do not have a grace period or provide for a carryover—despite the general rule that an FSA can adopt either a grace period or provide for a carryover amount but cannot have both (which otherwise continues in effect).
- ☑ The carryover relief applies to all FSAs, including HSA-compatible health FSAs, and also applies to all DCAPs.
- ☑ An employer may limit the carryover to an amount less than all unused amounts.
- ☑ An employer may limit the carryover to apply only up to a specified date during the plan year.

## Impact on Eligibility to Contribute to an HSA

Under existing rules, coverage by a general-purpose health FSA disqualifies an otherwise eligible individual from contributing to an HSA, whereas coverage by an HSA-compatible health FSA (such as a limited-purpose or post-deductible health FSA) does not do so.

The Notice provides that:

- An individual is not eligible to make contributions to an HSA during a month in which the individual participates in a general-purpose health FSA to which unused amounts are carried over to the 2021 or 2022 plan year pursuant to the CAA.
- Employers may amend their plans to allow employees, on an employee-by-employee basis, to opt out of the carryover to preserve their HSA eligibility.

Notwithstanding the above, the Notice provides information regarding the conversion of a general-purpose health FSA to an HSA-compatible health FSA to permit individuals with a health FSA carryover to qualify to make contributions to an HSA.

## Extended Grace Period Relief

The CAA allows employers to extend the grace period to apply unused amounts remaining in a health FSA or DCAP for plan years ending in 2020 or 2021, to 12 months after the end of that plan year.

**Example:** If an employer sponsored a calendar year cafeteria plan with a health FSA in 2020, the employer may amend the plan to permit employees to apply the entire unused amount remaining in their health FSAs as of Dec. 31, 2020, to reimburse medical care expenses incurred through Dec. 31, 2021.

The Notice clarifies that an employer may choose to adopt:

- An extended grace period that is less than 12 months; or
- A period that ends before the end of the plan year, during which employees who have ceased participation in a plan may continue to receive reimbursements.



Like the carryover relief, the extended grace period relief is available to cafeteria plans that currently have a grace period or provide for a carryover, as well as plans that do not have a grace period or provide for a carryover—despite the general rule that an FSA can adopt either a grace period or provide for a carryover amount but cannot have both (which otherwise continues in effect).

## Impact on Eligibility to Contribute to an HSA

According to the Notice, an individual is not eligible to make HSA contributions if the individual participates in a general-purpose health FSA, including during any extended grace period in which the participant can incur claims. However, the Notice provides information regarding the conversion of a general-purpose health FSA to an HSA-compatible health FSA. Employers also are permitted to amend their plans to allow employees, on an employee-by-employee basis, to opt out of any extended grace period in plan years ending in 2021 and 2022, to preserve their HSA eligibility.

## Post-termination Health FSA Reimbursements

The CAA provides that a health FSA may allow employees who **cease participation during calendar year 2020 or 2021** to continue to receive reimbursements from unused amounts through the end of that plan year (including any grace period, extended or not). Employers are permitted to limit the unused amounts in the health FSA to the amount of contributions the employee had made from the beginning of the plan year in which participation ceased, up to the date of cessation.

This option is available for an employee who ceases to be a participant as a result of:

- Termination of employment;
- Change in employment status; or
- A new election during calendar year 2020 or 2021.

## Interaction of Carryover and Extended Grace Period Relief

Amounts carried over or available during an extended grace period will not be taken into account for purposes of:

- The cafeteria plan and DCAP nondiscrimination rules;
- Determining the annual contribution limit applicable for the following year; or
- Determining whether a health FSA satisfies the maximum benefit payable limit condition under the ACA excepted benefits regulations.

## Carryovers & Grace Periods for Plan Years Ending in 2022

The otherwise applicable rules regarding carryovers and grace periods will apply for plan years ending in or after 2022, as illustrated in the table below.

Plans with a grace period for plan years ending in 2022	
	The grace period would allow a participant to use all unused amounts remaining at the end of the plan year ending in 2022 for expenses incurred during the first 2 ½ months of the plan year ending in 2023.



## Plans providing for a carry over for plan years ending in 2022

The carryover would allow the participant to use up to \$550 (or, if greater, 20% of the indexed FSA contribution limit) of unused amounts remaining at the end of the 2022 plan year for expenses incurred during any month of the plan year ending in 2023.

In accordance with otherwise applicable rules, for plan years ending in or after 2022, the carryover is available only for a health FSA and is not available for a DCAP.

## Carryovers & Extended Grace Period Relief Examples

The following examples illustrate the application of the above rules and assume that the applicable carryover limit continues to be \$550 for all relevant periods.

### EXAMPLE 1

Employer provides a health FSA that allows a \$550 carryover from one plan year to the next. Pursuant to the CAA, Employer amends the plan to adopt a 12-month temporary extended grace period for the 2020 plan year, allowing claims incurred on or after Jan. 1, 2021, but prior to Jan. 1, 2022, to be paid with amounts remaining from the 2020 plan year.

- As of Dec. 31, 2020, Employee A has a remaining balance of \$2,000 in a health FSA for the 2020 plan year.
- For the 2021 plan year, Employee A elects to contribute \$2,000 to a health FSA.
- Between Jan. 1, 2021, and Dec. 31, 2021, Employee A incurs \$3,300 in medical care expenses.
- **The health FSA may reimburse Employee A \$3,300, leaving \$700 in the health FSA as of Dec. 31, 2021.**

For the 2021 plan year, Employer also amends the plan to adopt the 12-month temporary grace period, allowing claims incurred on or after Jan. 1, 2022, but prior to Jan. 1, 2023, to be paid with amounts remaining at the end of the 2021 plan year.

- For the 2022 plan year, Employee A elects to contribute \$1,500 to a health FSA.
- Between Jan. 1, 2022, and Dec. 31, 2022, Employee A incurs \$1,200 in medical care expenses.
- **The health FSA may reimburse Employee A \$1,200, leaving \$1,000 in the health FSA as of Dec. 31, 2022 (\$700 from 2021 + \$300 remaining from 2022).**

Under the plan terms that provide for a \$550 carryover from the 2022 plan year to the 2023 plan year, **Employee A is allowed to use \$550 of the remaining \$1,000 in the health FSA during the 2023 plan year to reimburse expenses incurred on or after Jan. 1, 2023, and before Jan. 1, 2024. The \$450 remaining as of Dec. 31, 2022, is forfeited. A 2 ½ month grace period is not available for the plan year ending on Dec. 31, 2023, because the plan provides for a carryover.**

### EXAMPLE 2

Employer provides a health FSA under a non-calendar year cafeteria plan (July 1 to June 30) that allows a \$550 carryover from one plan year to the next. Pursuant to the CAA, Employer amends the plan to adopt a 12-month temporary grace period for the 2020 plan year, allowing claims incurred on or after July 1, 2021, but prior to July 1, 2022, to be paid with amounts from the 2020 plan year (which ends on June 30, 2021).

- For the 2020 plan year, Employee B elects to contribute \$1,800 to a health FSA. As of June 30, 2021, Employee B has the full balance of \$1,800 remaining.

- For the 2021 plan year, Employee B elects to contribute \$1,000 to a health FSA.
- Between July 1, 2021, and June 30, 2022, Employee B incurs \$2,000 in medical care expenses.
- **The health FSA may reimburse Employee B \$2,000, leaving \$800 in the health FSA as of June 30, 2022.**

Under the plan terms that provide for a carryover, **Employee B is allowed to use \$550 of the remaining \$800 in the health FSA during the 2022 plan year to reimburse expenses incurred on or after July 1, 2022, but prior to July 1, 2023. The \$250 remaining as of June 30, 2022, is forfeited. A 2 ½ month grace period is not available for the plan year ending June 30, 2022, because the plan provides for a carryover.**

## EXAMPLE 3

Employer provides a DCAP under a calendar year cafeteria plan. Pursuant to the CAA, Employer amends the plan to adopt a 12-month temporary extended grace period for the 2020 plan year, allowing claims incurred on or after Jan. 1, 2021, but prior to Jan. 1, 2022, to be paid with amounts remaining from the 2020 plan year.

- As of Dec. 31, 2020, Employee C has a remaining balance of \$4,000 in the DCAP for the 2020 plan year.
- For the 2021 plan year, Employee C elects to contribute \$3,000 to the DCAP.
- Between Jan. 1, 2021, and Dec. 31, 2021, Employee C incurs \$6,000 in dependent care expenses.
- **The DCAP may reimburse Employee C \$6,000, leaving \$1,000 in the DCAP as of Dec. 31, 2021.**

Employer also amends the plan to adopt a 12-month temporary extended grace period for the 2021 plan year, allowing claims incurred on or after Jan. 1, 2022, but prior to Jan. 1, 2023, to be paid with amounts remaining at the end of the 2021 plan year.

- For the 2022 plan year, Employee C elects to contribute \$2,000 to a DCAP.
- Between Jan. 1, 2022, and Dec. 31, 2022, Employee C incurs \$2,800 in dependent care expenses.
- **The DCAP may reimburse Employee C \$2,800, leaving \$200 in the DCAP as of Dec. 31, 2022. A carryover is not available for the DCAP from the 2022 plan year to the 2023 plan year. Employer adopts a 2 ½ month grace period for the 2022 plan year, during which the \$200 remaining as of Dec. 31, 2022, may be applied to reimburse dependent care expenses incurred during the grace period.**

## Election Changes

The CAA provides that cafeteria plans may permit employees to make prospective mid-year election changes for health FSAs and DCAPs for plan years ending in 2021, even if they have not experienced a change in status. Specifically, employers may allow employees to prospectively revoke an election, make one or more elections, or increase or decrease an existing election for plan years ending in 2021 regarding a health FSA or DCAP.

The Notice illustrates the discretion employers have in implementing this election relief. Specifically, employers are permitted to:

- Limit mid-year election changes to health FSAs and DCAPs to amounts no less than amounts already reimbursed and to certain types of mid-year election changes, such as decreases in elections only.
- Allow mid-year election changes without a change in status up to a certain date during the plan year, but require a change in status after that date (e.g., no status change is required if an election is changed before March 31, 2021, but a status change is required for election changes after that date).





- Limit the number of election changes during the plan year that are not associated with a change in status (e.g., allowing only one election change in the 2021 plan year without a status change).
- Limit the period during which election changes may be made.

## Initial Elections

The Notice clarifies that prospective election changes **may include an initial election to enroll in a health FSA or DCAP for the year** (e.g., to gain use of the carryover or extended grace period relief), if the employee initially declined to enroll in the health FSA or DCAP for the year.

Although election changes may only be applied prospectively, employers may allow employees to use funds contributed to a health FSA or DCAP following a revised election to reimburse expenses incurred at any time during the first plan year that begins on or after Jan. 1, 2021, through the end of the 2021 plan year. **This relief extends to expenses incurred by employees who were not enrolled in the health FSA or DCAP on Jan. 1, 2021.**

**Note:** This relief does not allow unused amounts to be paid to an employee in cash or paid to an employee in the form of any taxable or nontaxable benefit without regard to whether the employee incurs medical or dependent care expenses during the period of coverage.

*Employers may allow employees to use health FSA or DCAP funds that are contributed following a mid-year election to reimburse expenses incurred **at any time during the first plan year that begins on or after Jan. 1, 2021, through the end of the 2021 plan year.** This includes expenses incurred by employees who were not initially enrolled in the health FSA or DCAP on Jan. 1, 2021.*

## Prospectively Revoking Elections

If a health FSA or DCAP election is revoked, the treatment of amounts previously contributed is subject to the terms of the plan, which must apply uniformly to all participants. The plan may provide that amounts contributed before the revocation:

- Remain available for the rest of the plan year;
- Will be available only for expenses incurred before the revocation takes effect (and not later expenses); or
- Will be forfeited.

In addition, employers can allow employees to elect to revoke elections under a health FSA or DCAP as of a future specified date.

### **Impact on Eligibility to Contribute to an HSA**

If the plan provides that election revocation terminates participation in the health FSA, and that no subsequent reimbursements will be available (regardless of when the expense is incurred), following the revocation, the health FSA will no longer be treated as health coverage that disqualifies an otherwise eligible individual from contributing to an HSA. In this case, an otherwise eligible individual may begin contributing to an HSA as soon as the termination of participation is effective.

Similarly, if the health FSA reimburses only expenses incurred before the revocation date, following the revocation, the health FSA will not be treated as health coverage that disqualifies an otherwise eligible individual from contributing to an HSA for the months after the revocation date.

The examples below illustrate these rules.



## EXAMPLE 1

During the regular enrollment period for the 2021 calendar plan year, employee elects to contribute \$1,200 to a health FSA for the year. The plan allows the employee to revoke or change the election by March 1, 2021.

The employee makes a prospective election to revoke the election effective March 1, at which time the employee has contributed \$200 to the health FSA. Under the terms of the plan, amounts contributed before the revocation remain available to reimburse medical care expenses incurred for the rest of the plan year and, therefore, the employee may use the \$200 previously contributed to the health FSA to reimburse medical care expenses incurred throughout 2021.

Consequently, the employee has coverage by the health FSA for 2021 and will not be eligible to contribute to an HSA for calendar year 2021 even if otherwise eligible (i.e., covered by a high deductible health plan), unless the plan allows the employee to opt out of this extended grace period, and the employee does so.

## EXAMPLE 2

Same facts as Example 1, except that under the terms of the plan, revocation means that the employee may use the \$200 that was contributed to the health FSA prior to March 1 to reimburse only medical care expenses incurred prior to March 1. The coverage during January and February will not make the employee ineligible to contribute to an HSA during the rest of the plan year if otherwise eligible.

## Special Age Limit Relief for DCAPs

The CAA includes a special carry forward rule for dependent care FSAs where the dependent aged out during the pandemic. Specifically, for purposes of determining dependent care assistance that may be paid or reimbursed, the maximum age is increased from 13 to 14 years of age. Only certain employees are eligible for this relief.

The Notice makes clear that this special age limit relief does not permit an employer to reimburse expenses for a child who is 14 years or older. If an employer adopts this relief, then **all amounts from the most recent plan year with regard to which the regular enrollment period ended on or before Jan. 31, 2020, may be applied to dependent care expenses for a dependent who attained age 13 during that plan year.** In this case, employers may allow employees to carry over all unused amounts from that first plan year to reimburse dependent care expenses during the subsequent plan year (until that dependent attains age 14).

Lastly, the Notice clarifies that this special age limit relief is separate from the general carryover and extended grace period relief. Thus, employers are **not** required to adopt the carryover or extended grace period relief in order to adopt the special age limit relief.

## Plan Amendments

### General Requirements

Employers deciding to implement the CAA and the Notice relief for one or more of its cafeteria plans (including plans that do not currently have a grace period or permit a carryover) must adopt a plan amendment to do so. Such an amendment may be effective retroactively to the beginning of the applicable plan year, so long as:



- The amendment is adopted by the last day of the first calendar year following the plan year in which it is effective; and
- The plan operates consistently with the amendment terms until the amendment is adopted.

**Example:** If an employer sponsors a cafeteria plan with a health FSA that provides for a \$550 (from 2020 to 2021) and amends the plan to carry over the entire unused amount remaining in employees' health FSAs as of Dec. 31, 2020, to the 2021 plan year, the amendment must be adopted by Dec. 31, 2021. An amendment for the 2020 plan year of a non-calendar year plan, however, must be adopted by Dec. 31, 2022, because the last day of the first calendar year beginning after the end of the 2020 plan year that ends in 2021 is the last day of 2022.

## Amendments Incorporating Carryover and Extended Grace Period Relief

An employer **may not amend its plan to adopt both the carryover and the extended grace period** for a particular plan year for a particular health FSA or DCAP, and an amendment must specify which option is adopted for the applicable plan years. An employer can adopt this relief for some, but not all, health FSA or DCAP participants (subject to applicable nondiscrimination rules under Internal Revenue Code Sections 125 and 129). An employer may also choose to adopt one type of relief, or no relief, for a health FSA and a different type of relief, or no relief, for a DCAP. An employer that offers multiple health FSAs or DCAPs may also adopt differing relief for each particular health FSA or DCAP.

## Impact on COBRA

### Adopting Carryover or Extended Grace Period Relief

If an employer adopts a carryover or extended grace period under the CAA, the maximum amount that the health FSA may require to be paid as the applicable COBRA premium does not include unused amounts carried over or available during the extended grace period. Thus, if a qualified beneficiary is allowed a carryover to a later plan year or an extended grace period, the applicable COBRA premium payable to provide access to the carryover amounts or the amounts attributable to the extended grace period for that later year or for the extended grace period is **zero**.

In addition, amounts carried over or available during the extended grace period are included in the amount of the benefit that a qualified beneficiary is entitled to receive during the remainder of a plan year in which a qualifying event occurs.

### Adopting Post-termination Health FSA Reimbursement Relief

If an individual is otherwise a qualified beneficiary with respect to coverage by a health FSA, the limited post-termination health FSA reimbursement period **will not prevent the individual from having a loss of coverage resulting in a qualifying event** (for example, by termination of employment or reduction in hours of a covered employee), and the relevant employer will be subject to COBRA's notice requirements.

**Example:** If an employer allows an employee who ceases participation as the result of termination of employment or change in employment status to be reimbursed for expenses incurred after the termination or reduction in hours, through access to contributions made as of the date employee participation ceased, this event would constitute a COBRA qualifying event subject to notice requirements.