February 23, 2021

IRS Clarifies COVID-19 Relief for Flexible Spending Accounts

On February 18, the Internal Revenue Service (IRS) published Notice 2021-15 (Notice), providing much anticipated guidance clarifying the temporary special rules for health care and dependent care flexible spending accounts (FSAs) that were included in the Tax Certainty and Disaster Relief Act (Act) enacted on December 27, 2020. The Notice also provides additional relief allowing midyear elections for employer-sponsored health coverage and confirms the amendment deadlines for both changes under the Act and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).

What Do Employers Need to Know?

The Notice provides employers with enormous flexibility in choosing how the Act's temporary special rules will apply in light of employers' concerns about cost and FSA administration, while trying to maximize employees' access to unused funds. Similar flexibility is provided with respect to the Notice's additional relief for midyear elections for employer-sponsored health coverage. Accordingly, employers should carefully review all available options and determine which special rules they want to adopt. Employers should discuss implementation of the changes with their FSA vendor, prepare appropriate employee communications and ensure that all necessary amendments are adopted in a timely manner.

Background

Health care FSAs, dependent care FSAs, and the cafeteria plans through which employees elect to contribute to FSAs and/or contribute their share of the premium for employer-sponsored health coverage are subject to strict rules that (i) can result in employees forfeiting amounts they do not use by the end of the plan year, (ii) generally limit the circumstances under which employees may change their cafeteria plan elections during the year and (iii) require amendments to apply on a prospective basis only. Additionally, health care FSAs are subject to the "uniform coverage" rule, which requires the full amount elected for the year to be immediately available for reimbursement. Finally, health savings accounts (HSAs), which allow individuals covered by a high deductible health plan to make deductible contributions for the payment of certain medical expenses, are not available to individuals covered by "general purpose" health care FSAs, i.e., those FSAs that will reimburse all qualified medical expenses. In contrast, individuals can maintain HSA eligibility if they are covered by "limited purpose" FSAs that limit reimbursement to certain medical expenses, such as dental and vision benefits.

In response to the COVID-19 pandemic, Congress and the IRS have taken several steps to ease the application of these strict rules. Most recently, Congress enacted the Act, which includes several alternatives designed to limit forfeitures in FSAs. (See our prior alert.) Earlier in 2020, the IRS issued Notice 2020-29, which extended to December 31, 2020, the period during which employees could apply unused health care FSAs and dependent care FSAs remaining at the end of a fiscal plan year or grace period ending in 2020 and broadened the circumstances in which employees could change their cafeteria plan elections for 2020. (See our prior alert.) As part of the CARES Act, Congress expanded the list of medical expenses that can be reimbursed from health care FSAs to include over-the-counter drugs without prescription and menstrual care products purchased on or after January 1, 2020.

What Does the Notice Provide?

The Notice summarizes the temporary special rules for health care FSAs and dependent care FSAs and discusses options for implementation, taking into account existing guidance. Similarly, the Notice sets forth the options for allowing midyear

election changes for employer-sponsored health coverage for the 2021 plan year. The Notice provides guidance on a number of issues raised by the existing relief, including but not limited to the following:

- Employers adopting the temporary carryover rules may limit the amount of the carryover, may limit the use of the carryover to claims incurred up to a specified date and may require employees to enroll in the applicable FSA for the current year to have access to the unused amounts from the prior year. If current-year enrollment is required, the carryover could be made available to an employee who enrolls midyear on a prospective basis under the temporary relief.

- Employees subject to a health care FSA carryover can be permitted to opt out of the carryover to preserve their HSA eligibility, or can be permitted to choose between a limited purpose FSA or a general purpose FSA in order to preserve HSA eligibility. A midyear election by an employee to participate in a limited purpose FSA will allow the employee to contribute to the HSA prospectively.
- Employers adopting the temporary post-termination reimbursement rules for health care FSAs are permitted to limit the amount available for reimbursement to the amount of the salary contributions made by the participant through to the date the participant ceased participating.

- If a health care FSA or dependent care FSA election is revoked midyear, the employer can choose to forfeit all contributions made before the revocation, limit reimbursement to expenses incurred before the revocation or provide for reimbursement of expenses incurred during the rest of the plan year, as long as the terms are provided uniformly to all participants. If revocation of a health care FSA results in forfeiture, the employee will be treated as prospectively eligible to contribute to an HSA.

- An employer that adopts the Act's temporary post-termination reimbursement rules for health care FSAs must still comply with COBRA's notice requirements in the event of a qualifying event such as termination of employment. An employer can, but need not, limit post-termination reimbursement to employees who elect COBRA. If post-termination reimbursement is provided to an employee who ceases to be a participant and has not elected COBRA, the amount available for reimbursement is the existing amount in the health care FSA as of the date the employee ceased being a participant.

- The tax reporting requirements for dependent care FSAs are not altered by the Act's temporary rules allowing for carryovers.

- Retroactive amendments to adopt the CARES Act's expanded reimbursable medical expenses are permitted if they are adopted within the time period applicable to the amendment-adopting provisions of the Act, i.e., no later than the end of the calendar year following the plan year in which they are effective.

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If you have specific questions regarding how the Notice could apply to your health care FSA, dependent care FSA or cafeteria plan, or you need assistance preparing plan amendments or employee communications, please reach out to any of the attorneys in Day Pitney's ERISA and Executive Compensation group.

For more Day Pitney alerts and articles related to the impact of COVID-19, as well as information from other reliable sources, please visit our COVID-19 Resource Center.

COVID-19 DISCLAIMER: As you are aware, as a result of the COVID-19 pandemic, things are changing quickly and the effect, enforceability and interpretation of laws may be affected by future events. The material set forth in this document is not an unequivocal statement of law, but instead represents our best interpretation of where things stand as of the date of first

publication. We have not attempted to address the potential impacts of all local, state and federal orders that may have been issued in response to the COVID-19 pandemic.

Authors



David P. Doyle
Partner

Parsippany, NJ | (973) 966-8136

ddoyle@daypitney.com



Thomas F. J. O'Mullane
Partner

Parsippany, NJ | (973) 966-8413

tomullane@daypitney.com