

Employee Benefit Plan Review

IRS Issues Guidance on Consolidated Appropriations Act FSA Forfeiture Relief

BY JULIA ANN LOVE, DOMINIC DEMATTIES, KIM WILCOXON,
AND BETH A. MANDEL

The U.S. Treasury Department and Internal Revenue Service (“IRS”) issued much anticipated guidance (“IRS Notice 2021-15”)¹ related to the flexible spending account (“FSA”) forfeiture relief enacted late last year under the Consolidated Appropriations Act, 2021 (“CAA”).²

OVERVIEW

Continuing the trend of prior FSA relief related to COVID-19, the CAA includes a number of provisions that temporarily relax flexible spending account rules to allow plan sponsors to mitigate participant losses under health care and dependent care FSAs.

That relief, explained in greater detail below, includes the following temporary relief:

- Two options – an unlimited carryover or extended grace period – that allow participants to continue to spend down prior year unused health care and dependent care FSA funds for plan years ending in 2020 and 2021. For each FSA (health care or dependent care), plan sponsors can adopt one or neither of the options, but cannot adopt both. For health care FSAs, the relief is not limited to general purpose FSAs; it can be applied to health savings account (“HSA”) compatible FSAs (e.g., limited purpose or post-deductible FSAs).
- Post-termination health care FSA relief for 2020 and 2021 plan years.
- Use of 2020 dependent care FSA funds for children turning 13 during the 2020 or 2021 plan years.

Relief	Amendment Deadline (for Calendar Year Plan)
Adopt unlimited carryover or extended grace period for the 2020 plan year	December 31, 2021
Adopt unlimited carryover or extended grace period for the 2021 plan year	December 31, 2022
Adopt mid-year election relief for the 2021 plan year	December 31, 2022

- Relaxed mid-year election rules for health care and dependent care FSAs for plan years ending in 2021.

Notably, the relief does not allow participants to receive refunds of any unused contributions at any time.

The recent IRS guidance answers key questions about the parameters of that relief and provides the following additional relief:

- Additional mid-year election relief for employer-sponsored health plans (e.g., medical, dental, and vision plans) for plan years ending in 2021.
- Additional guidance with respect to the timing of amendments to expand health care FSA and health reimbursement account coverage for over-the-counter drugs without prescriptions and menstrual care products, as permitted by the CARES Act.

The relief is permissive, not required. Plan sponsors can choose to adopt any portion or none of the relief.

The accompanying table shows the key differences (and in some cases, similarities) between the standard cafeteria plan rules and the above-described relief.

HOW WILL ALL OF THIS WORK?

The following Q&As address some of the questions answered by the IRS with respect to the implementation of this relief.

Q *How can plan sponsors adopt this relief?*

A To adopt this relief, the employer or plan sponsor must adopt a plan amendment and notify all employees eligible to participate in the plan of the plan changes.

In general, if adopting the relief described above:

- The plan sponsor may amend the plan on a retroactive basis,

as long as the plan is operated in accordance with the adopted relief as of the effective date of the amendment; and

- The amendment must be adopted by the end of the first calendar year beginning after the end of the plan year in which the amendment is effective.

Examples of the amendment deadlines as applied to a calendar year plan are shown in chart above.

Q *What is the difference between the unlimited carryover and extended grace period designs? Do they both allow participants to spend down unused amounts from one year's account during the following year?*

A Functionally, those options are similar. However, there are some important differences.

First, the unlimited carryover and extended grace period options interact differently with the post-termination health care FSA relief. As shown in the examples below, the grace period relief provides an extra year for terminated participants to spend down their accounts.

Example 1 – Post-Termination Relief and Unlimited Carryover

Company A sponsors a calendar-year health care FSA that normally does not provide for carryover or a grace period. For the 2021 plan year, Company A adopts the post-termination relief (limited to actual unused contributions) and the unlimited carryover relief (meaning participants will be permitted to carry over their full unused balance from 2021 to 2022). Bob terminates participation in the health care FSA effective August 31, 2021, with \$1,000 remaining in unused contributions. Bob has until December 31, 2021 to spend down those unused amounts. If Bob incurs less than \$1,000 in eligible expenses by that deadline, the unused amounts will be forfeited.

Example 2 – Post-Termination Relief and Extended Grace Period

Company B sponsors a calendar-year health care FSA that normally does not provide for carryover or a grace period. For the 2021 plan year, Company B adopts the post-termination relief (limited to actual unused contributions) and the maximum extended grace period relief (meaning participants will be permitted to continue to incur claims for reimbursement from their 2021 health care FSAs through December 31, 2022). Bob terminates participation in the health care FSA effective August 31, 2021, with \$1,000 remaining in unused contributions. Bob will have the remainder of 2021 and the associated 12-month extended grace period (i.e., until December 31, 2022) to spend down those unused amounts. Accordingly, in this example, Bob has a full 16 months to spend his unused funds, versus four months in Example 1.

Second, the carryover design allows unused funds to continue to be carried over from year to year (i) on an unlimited basis from 2020 to 2021 and from 2021 to 2022, and (ii) subject to the standard cap, for future years for health care FSAs. By contrast, the extended grace period allows continued use of the funds only during the extended grace period.

Example 1 – Unlimited Carryover

Company A sponsors a calendar-year health care FSA and adopts the unlimited carryover relief (meaning participants will be permitted to carry over their full unused balance from 2020 to 2021 and from 2021 to 2022).

- Cathy has \$2,000 remaining in her account as of December 31, 2020 and elected to contribute \$2,000 to her account for 2021. Cathy may be reimbursed up to \$4,000 for 2021 expenses.
- Cathy receives reimbursement of only \$1,000 in 2021 and has \$3,000 remaining in her account as of December 31, 2021. She

also elects to contribute \$2,000 for 2022. Cathy may be reimbursed up to \$5,000 for 2022 expenses.

- Cathy receives reimbursement of only \$1,000 in 2022 and has \$4,000 remaining in her account as of December 31, 2022. Cathy can carry over \$550 (or the adjusted maximum carryover amount applicable for that year) to her 2023 account and must forfeit the remaining \$3,450.

Example 2 – Extended Grace Period

Company B sponsors a calendar-year health care FSA and adopts the extended grace period relief (meaning participants will be permitted to continue to incur claims for reimbursement from their 2020 health care FSAs through December 31, 2021 and for their 2021 health care FSAs through December 31, 2022).

- Cathy has \$2,000 remaining in her 2020 account after reimbursement of all 2020 expenses, and she elected to contribute \$2,000 to her account for 2021. Cathy may be reimbursed up to \$4,000 (\$2,000 from the 2020 account and \$2,000 from the 2021 account) for 2021 expenses.
- Cathy receives reimbursement of only \$1,000 for 2021 expenses, which means she has \$1,000 left in her 2020 account and \$2,000 left in her 2021 account. She also elects to contribute \$2,000 for 2022. Cathy must forfeit the \$1,000 remaining from 2020 and may be reimbursed up to \$4,000 (\$2,000 from her 2021 account and \$2,000 from her 2022 account) for 2022 expenses.
- Cathy receives reimbursement of only \$1,000 for 2022 expenses, which means she has \$1,000 left in her 2021 account and \$2,000 left in her 2022 account. Cathy must forfeit the \$1,000 remaining from 2021 and has until only

March 15, 2023 to use up the \$2,000 remaining from her 2022 account.

Q How does this relief impact HSA compatibility?

A Although this relief does not change the general rule that an individual participating in a general purpose health care FSA is not eligible to contribute to an HSA, it provides new options to help participants avoid such ineligibility.

Participants will be HSA-ineligible during periods when:

- They participate in a general purpose health FSA to which unused amounts are carried over; or
- They continue to be eligible to receive reimbursements from a general purpose health care FSA during an extended grace period or post-termination period.

The IRS has provided several options for preserving HSA eligibility. Specifically:

- Plan sponsors can amend their plans to allow an employee to make a mid-year election to cease participating in a general purpose health care FSA and commence participation in an HSA-compatible health care FSA, with unused FSA amounts being transferred to the new HSA-compatible FSA. The reverse is also permitted. In those cases, the employee's permissible HSA contribution will be based on the number of months during which the employee is not covered under the general purpose FSA and is otherwise HSA-eligible.
- Plan sponsors can implement a plan design in which employees who elect HDHP coverage and health care FSA coverage are automatically enrolled in an HSA-compatible FSA (regardless of whether the plan sponsor has elected the unlimited carryover

relief or the extended grace period relief).

- Plan sponsors can implement a plan design in which employees may elect whether funds available as a result of the unlimited carryover or the extended grace period are HSA-compatible funds.
- Plan sponsors can implement a plan design in which employees may opt out of the unlimited carryover or the extended grace period and voluntarily forfeit any unused funds.

Q Can plan sponsors adopting the mid-year election relief apply limits to that relief?

A Yes. Similar to last year, plan sponsors have broad flexibility to set their own limits to the mid-year election relief. For example, a plan sponsor may choose to limit the time period during which participants can exercise that relief (e.g., by implementing a specific election-change window). A plan sponsor also may limit types of election changes permitted (e.g., by allowing participants to decrease health care FSA elections only to the greater of the amount they have already contributed or the amount they have received in reimbursements for the plan year).

Q We have decided to adopt the post-termination health care FSA relief and allow terminating participants to continue to use the amounts they have already contributed to their health care FSAs (not their full elected amounts) through the end of the plan year. Do we still have to offer COBRA?

A Yes. A participant who terminates employment or loses eligibility due to a reduction in hours must be offered COBRA in these circumstances. That participant must be given the choice between (i) continuing access to unused contributions, or (ii) electing COBRA to

Key Features of Relief	Standard Cafeteria Plan Rules	CAA/IRS Relief
FSA Carryover	Carryover for health care FSAs is subject to a maximum cap (\$550 for carryover from the 2020 to the 2021 plan year).	Plan sponsors can allow carryover of up to the full balance remaining in a participant’s health care FSA account from the 2020 plan year to the 2021 plan year and from the 2021 plan year to the 2022 plan year.
	Carryover is not permitted for dependent care FSAs.	The unlimited carryover relief can be applied to dependent care FSAs.
	Cannot be combined with a grace period plan design.	The relief can be adopted for FSAs that currently include a standard grace period or carryover or by plans that currently do not provide for carryover or a grace period.
	Plan sponsors implementing a standard health care FSA carryover feature can require participants to elect to enroll in the FSA with a minimum contribution in order to get access to carried over amounts from the prior year.	Plan sponsors can apply the same requirement to health care and dependent care FSAs when adopting the carryover relief.
	Health care FSA amounts may be used only for qualified medical care expenses, and dependent care FSA amounts may be used only for qualified dependent care expenses.	The same rule applies to the relief. A plan sponsor cannot transfer or carry over funds from a dependent care FSA to a health care FSA or vice versa.
	Amounts carried over from a prior year do not impact contribution limits for the current year.	This rule is unchanged.
FSA Grace Period	Grace period cannot extend beyond the 15th day of the third month immediately following the end of the plan year (i.e., March 15 for a calendar year plan).	Grace periods for plan years ending in 2020 and 2021 can be extended up to 12 months after the plan year (i.e., for a 2020 calendar year FSA, a plan sponsor can adopt this relief to give participants up to December 31, 2021 to incur claims for reimbursement from their 2020 FSA funds).
	Cannot be combined with a carryover feature.	The relief can be adopted for FSAs that currently include a standard grace period or carryover or by plans that currently do not provide for carryover or a grace period.
	Amounts available for use during the grace period do not impact contribution limits for the current year.	This rule is unchanged.
Post-Termination Health Care FSA Relief	A plan may include a “spend-down” provision for a dependent care FSA. Under such a provision, the FSA will reimburse a participant for otherwise-eligible expenses incurred during the plan year and any associated grace period – even after ceasing participation mid-year (e.g., due to termination of employment or loss of eligibility). This option is not available under a health care FSA, so post-termination health care expenses may not be reimbursed unless the participant elects to continue coverage under COBRA.	Plan sponsors can adopt a spend-down provision for the health care FSA for employees who cease participation during calendar years 2020 or 2021. Under the spend-down provision, the FSA may reimburse otherwise-eligible expenses incurred through the end of the plan year in which participation ceased (and any associated grace period). Plan sponsors can choose to adopt this relief for employees who cease to be participants as the result of termination of employment, change in employment status, and/or an election to cease contributions.

Key Features of Relief	Standard Cafeteria Plan Rules	CAA/IRS Relief
	The full amount of coverage elected by the participant (minus any amounts already reimbursed) must be made available for reimbursement at all times during the coverage period.	A plan sponsor adopting this relief can limit the amount available for post-termination reimbursement to the amount of contributions actually made by the participant (minus any amounts already reimbursed).
Increased Child Age Limit for Dependent Care Expenses	A participant can only be reimbursed for expenses incurred with respect to a child under age 13.	Unused 2020 dependent care FSA funds may be used to reimburse expenses incurred during the 2020 or 2021 plan years with respect to a child under age 14 who turned 13 during calendar year 2020 or 2021.
Mid-Year Election Relief	Group health plan and FSA participants can change their elections in the middle of the plan year only if they experience certain qualifying events, like a qualifying change in status or a HIPAA special enrollment event.	<p>Similar to relief provided last year, an employer may amend its cafeteria plan to permit any or all of the following prospective mid-year election changes for plan years ending in 2021, regardless of whether the basis for the election would satisfy otherwise applicable cafeteria plan regulations:</p> <ul style="list-style-type: none"> • Make a new election for health coverage (medical, dental, and/or vision), if the employee initially declined to enroll in such coverage for the current plan year.* • Revoke an existing election for health coverage, and make a new election to enroll in different health coverage sponsored by the same employer.* • Revoke an existing election for health coverage without making a new election, provided that the employee attests in writing that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer.* • Revoke an election, make one or more new elections, or decrease or increase an existing election for health care FSA or dependent care FSA coverage. <p>*Plan sponsors of fully-insured group health coverage should talk to their carriers before adopting any of the mid-year election relief for those plans.</p>
	Participants can seek reimbursement of expenses incurred only while they are participants under an FSA. For example, if a participant enrolls in a health care FSA mid-year on June 1, the participant cannot seek reimbursement for an expense incurred during May of that year.	Changes to salary reductions resulting from a revised FSA election must be applied prospectively. However, employers may allow amounts contributed to an FSA after a mid-year election change to be used for any eligible expenses incurred during the 2021 plan year. For example, plan sponsors of calendar year FSA plans can allow participants enrolling in an FSA mid-year to seek reimbursement for eligible expenses incurred on or after January 1, 2021 through December 31, 2021. If the participant was enrolled in an HDHP for any period prior to the date of the election, contributions to the FSA may be used only for HSA-compatible expenses incurred while the participant was enrolled in the HDHP.

Key Features of Relief	Standard Cafeteria Plan Rules	CAA/IRS Relief
Interaction with HSAs	A participant who participates in a health care FSA is not eligible to contribute to an HSA unless the health care FSA is designed as an HSA-compatible FSA.	This rule is unchanged.
	A participant generally cannot switch from a general purpose health care FSA to an HSA-compatible health care FSA during the plan year.	A plan sponsor may allow employees to convert their general purpose health care FSAs to HSA-compatible health care FSAs during the 2021 plan year.
	A participant who has funds remaining in a general purpose health care FSA at the end of a plan year is not eligible to contribute to an HSA during the associated grace period. The funds may not be converted to HSA-compatible funds during the grace period unless the cafeteria plan has been designed to automatically convert all general purpose health care FSAs to HSA-compatible FSAs for the entirety of the grace period.	Plan sponsors who adopt the CAA grace period relief may use either of the following options to prevent the grace period from disqualifying a participant from eligibility to make HSA contributions: <ul style="list-style-type: none"> • Provide for unused general purpose health care FSA funds to automatically convert to HSA-compatible funds; or • Allow each participant to choose whether their unused general purpose health care FSA funds will convert to HSA-compatible funds. In addition, a plan sponsor may allow participants to opt out of the extended grace period.
	A plan may be designed to: <ul style="list-style-type: none"> • Allow each participant to opt out of the carryover; and/or • Allow carryover funds to have the same character (general or HSA-compatible) as the account to which the funds are carried over. For example, amounts carried over from a general purpose health care FSA will be HSA-compatible funds for a participant who participates in an HSA-compatible FSA for that following plan year. 	The current rule is unchanged. In addition, plan sponsors who adopt the CAA carryover relief may allow each participant to choose whether amounts carried over from their unused general purpose health care FSA funds will convert to HSA-compatible funds.

continue access to the full election amount (minus reimbursements made to date).

Q *If we adopt either the unlimited carryover or extended grace period for our dependent care FSA, will this impact the amount we are required to report for dependent care contributions in Box 10 of employees' Forms W-2?*

A No. Consistent with previous reporting guidance, employers may report the salary reduction amount elected by the employee for the year (plus any employer matching contributions). Employers are not required to include amounts that remain available in a grace period

associated with the prior year or amounts that are carried over from a prior year.

Q *If we adopt the extended grace period or unlimited carryover relief, will that impact nondiscrimination testing for 2021 or 2022?*

A No. The IRS clarified in Notice 2021-15 that plans do not need to take into account amounts carried over or made available during an extended grace period for purposes of cafeteria plan and dependent care assistance program nondiscrimination testing. 🌐

NOTES

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

2. Pub. L. 116-260, 134 Stat. 1182 (Dec. 27, 2020).

Julia Ann Love (*julia.love@thompsonhine.com*), a partner in the Cleveland office of Thompson Hine LLP, is leader of the firm's Employee Benefits & Executive Compensation practice group. Dominic DeMatties (*dominic.dematties@thompsonhine.com*) is a partner in the firm's Employee Benefits & Executive Compensation practice group in Washington, D.C. Kim Wilcoxon (*kim.wilcoxon@thompsonhine.com*) is a partner in the firm's Employee Benefits & Executive Compensation practice group in Cincinnati. Beth A. Mandel (*beth.mandel@thompsonhine.com*) is an associate in the firm's Employee Benefits & Executive Compensation practice group in Cincinnati.

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