Five CAA Benefits Changes and their Tax-Exempt Entity Impact

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Although extraordinarily helpful to benefit plan participants, the coronavirus (COVID-19) tax relief available under the Consolidated Appropriations Act, 2021 (CAA) has caused many headaches for CFOs and other managers of tax-exempt (TE) entities. These headaches from CAA benefits changes have continued into 2022.

Additionally, the "Great Resignation" that followed the initial pandemic surge significantly increased the difficulty of finding and keeping the right talent for your TE's mission and purpose, making it more important than ever to offer generous health and dependent care benefits to attract and retain talented workforces. Further, the Great Resignation only added to the strains of attracting and retaining talent through traditional salary and compensation methods that TE entities were already feeling due to the Tax Cuts and Jobs Act's (TCJA) limits on their executive compensation programs. For these reasons, it's important to understand how the CAA's rules impacted (and continue to impact) health flexible spending accounts (FSAs), dependent care FSAs (DCAPs), and other types of health and welfare plans.

In January 2021, the CAA introduced major health and DCAP FSA relief that employers may offer to help address situations for employees who were not able to use FSA and DCAP funds due to circumstances caused by the pandemic. The following month, the IRS issued clarifications to explain in more detail the temporary health FSA and DCAP relief in the CAA.

These are the five major CAA benefits changes, along with a summary of the key clarifications issued in relevant IRS guidance:

1. **Permitted Carryover of Unused Health and DCAP FSA Funds**

For both health and DCAP FSAs, a plan may permit carryovers of the full unused balance from a plan year ending in the 2020 calendar year into 2021, and again from a plan year ending in the 2021 calendar year into 2022. Health FSAs have had the ability to permit a carryover for many years, but that amount was always capped (for example, in 2020 at $550). This change allowed the full balance of unused money in the prior year to be carried over. Additionally, it extended the ability to have a similar carryover for the DCAP plan when previously one was not permitted.

Key IRS Clarifications:

(1) The carryover amounts are not capped in any way unless by employer design.

(2) The carryover amount does not reduce the amount that can be elected in the next plan year (PY).

(3) The carryover amount is not considered in the subsequent year's nondiscrimination testing amount. This is a big deal for employers who have issues with passing non-discrimination testing because, if they were required to include the carryover amount, this could cause even larger failures and possible more taxation of income for highly compensated employees (HCEs).

Adding to the confusion, in April 2021, the American Rescue Plan Act of 2021 (ARPA) increased the DCAP contribution limit for qualifying dependent care expenses from $5,000 to $10,500. This effectively muddied the waters, and made carryovers even more complicated, particularly with regard to non–calendar year plans, which have unfortunate tax consequences for participants trying to take advantage of the special tax relief in 2022.

2. **Extended grace period of up to 12 months in which to incur expenses is permitted for PYs ending in 2020 or 2021.**

The IRS previously extended the grace period available for health FSAs and DCAPs to the end of calendar year for 2020. The CAA permits an even longer extension of the plan's grace period up to a maximum of 12 months for the 2020 and 2021 plan years.

Additionally, an employer that didn't have a grace period attached to its 2020 plan year could adopt one retroactively and the employer was also permitted to change from offering a grace period to offering the carryover provision or vice versa. However, a plan was not permitted to have both a grace period and a carryover.

3. **Post-termination health FSA spend-down following termination of participation in CYs 2020 or 2021**

Similar to the "spend down" option currently available under the dependent care FSA, a health FSA may permit employees who ceased participation mid-year during the 2020 or 2021 calendar year to continue to incur and be reimbursed for claims for the remainder of the plan year in which their participation ceased.

Ceasing participation in the health FSA or DCAP applies to those employees that terminate employment, but it could also be allowed for an employee who lost eligibility due to a change in employment status and who remains employed.

4. **Temporary expansion of an eligible DCAP dependent through age 13**

This relief allows employees with children who turned age 13 (previous limiting age) in the 2020 or 2021 plan year to be reimbursed for their expenses from the 2020 plan year balance (including carryover or grace period) for the period "through" age 13. In order to take advantage of this provision, the enrollment period for the DCAP with the unused funds must have been on or before January 31, 2020.

5. **Mid-year election changes are permitted without change in status event required**

Building on prior IRS election change relief for 2020, the CAA provides that the cafeteria plan may permit employees to change their health FSA or dependent care FSA election during plan years ending in 2021 without experiencing a previously required qualifying event. The election must be on a prospective basis, but the funds can be used for any medical care or dependent care expense, respectively, incurred during the first plan year that begins on or after January 1, 2021, through the end of the 2021 plan year even if that extends into 2022.

Plan Amendment

Employers that offered these optional health FSA or DCAP relief provisions under the CAA must amend their plan document to incorporate these changes. Specifically, they must adopt an amendment by the end of the first calendar year beginning after the end of the plan year in which the amendment is effective, and must operate their plans in accordance with the amendment's terms beginning on its effective date. Accordingly, for 2021 calendar-year plans that took advantage of this relief, these amendments are required by no later than December 31, 2022. ■

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