

Health and Dependent Care Flexible Spending Accounts and the COVID-19 Pandemic

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February 11, 2021 | 2021-R-0054

Issue

Explain federal rules that apply to health and dependent care flexible spending accounts (also called arrangements), including the “use it or lose it” rule, and summarize any relief from the rules available in response to the COVID-19 pandemic.

Summary

Health and dependent care flexible spending accounts (FSAs) are employer-sponsored benefit plans that allow employees to pay for certain health and dependent care expenses on a pre-tax basis. FSAs are governed by federal tax law, but their tax benefits pass through for Connecticut income tax purposes because the starting point for calculating state taxable income tax is federal adjusted gross income.

Federal rules require that employees participating in health or dependent care FSAs make an election at the beginning of a plan year to contribute a certain amount, up to the contribution cap, except under certain circumstances allowed under IRS rules (e.g., “status changes,” such as the birth of a child). The “use it or lose it” rule generally prohibits employees from rolling over unused funds from one plan year to the next, so employees must use the funds for expenses incurred within the plan year or forfeit them, with some exceptions.

But the COVID-19 pandemic caused unanticipated changes in people’s health and dependent care expenses, as schools and daycares closed temporarily, hospitals postponed elective procedures,

and people generally sought to minimize contact with others outside their households. Consequently, some health and dependent care FSA participants had lower or no eligible expenses and were at risk of losing funds they had already contributed or elected to contribute for the current plan year.

In response, the IRS (in May 2020) and Congress (in December 2020) adopted temporary rules allowing employers to offer some flexibility to their employees. These changes allow employers to, among other things, (1) allow mid-year contribution election changes on a prospective basis, (2) offer extended grace periods, and (3) allow funds to be carried over between plan years. Employers must adopt amendments to their plans in order to offer these options to employees, and they may apply these changes retroactively.

Background: General FSA Rules

Structure and Contribution Limits

Most health and dependent care FSAs are structured so that employees make contributions, referred to as “salary reduction contributions,” on a pre-tax basis through a Section 125 cafeteria plan. (A cafeteria plan is a written plan that allows employees to choose among two or more benefits consisting of cash—salary—and qualified benefits, including FSAs.) The health FSA contribution limit is established annually and adjusted for inflation; for the 2021 income year, it is \$2,750 ([26 U.S.C. § 125\(i\)](#), IRS Revenue Procedure [2020-45](#)). Generally speaking, the dependent care FSA contribution limit is \$5,000 for single and joint filers and \$2,500 for married individuals filing separately ([26 U.S.C. § 129](#)).

Election Changes

Participating employees select their amount of salary reduction contributions for the year at the beginning of the year. The selection is generally irrevocable, unless the employer’s plan allows employees to change their contributions under certain circumstances, as allowed under IRS regulations. Depending on the FSA type, these circumstances include, among others, (1) change in status events (e.g., a change in number of dependents or employment status), (2) significant cost or coverage changes (e.g., increase in child care provider rates), or (3) leave under the Family and Medical Leave Act ([26 C.F.R. § 1.125-4](#)).

“Use It or Lose It” Rule

Federal law generally prohibits Section 125 cafeteria plans from including deferred compensation benefits ([26 U.S.C. § 125\(d\)\(2\)](#)). The IRS has generally interpreted this to mean that participants cannot use contributions made in one plan year to pay for a benefit provided in the next year. Thus,

unused health and dependent care FSA funds are forfeited at the end of the plan year (known as the “use it or lose it” rule) ([IRS Notice 2005-42](#)). But employers may offer either a grace period or a carryover (but not both) to health FSA participants under certain circumstances. Employers may only offer grace periods for dependent care FSAs.

Grace Periods. Employers may offer grace periods to participants in health and dependent care FSAs. Under IRS rules, a grace period is a two-and-a-half-month period after the end of the plan year during which participants may use contributions made in the prior year to pay for qualified benefits received during the grace period. Employers may also offer “run out periods,” which provide employees time after the end of the coverage period to submit claims for eligible expenses that were incurred during the coverage period ([IRS Notice 2005-42](#)).

Carryovers. Under IRS rules, employers may allow participants in health FSAs to carryover a certain amount of funds remaining at the end of a plan year to the next plan year ([IRS Notice 2013-71](#)). The carryover limit is \$550 for the 2021 income year (IRS Revenue Procedure [2020-45](#)). Employers may not offer carryovers for dependent care FSAs.

IRS Administrative Flexibility

Principally in response to the COVID-19 pandemic, in May 2020, the IRS issued guidance providing increased flexibility to employees participating in health and dependent care FSAs through Section 125 cafeteria plans ([IRS Notice 2020-29](#)). The guidance temporarily authorizes employers to:

1. allow employees to establish, revoke, or modify health or dependent care FSA contributions mid-plan year on a prospective basis during calendar year 2020 and
2. allow unused funds remaining in a health or dependent care FSA at the end of a grace period or plan year ending in 2020 to be used to pay or reimburse expenses incurred through December 31, 2020.

The IRS also increased the carryover limit for health FSAs for plan years beginning in 2020 from \$500 to \$550 ([IRS Notice 2020-33](#)).

Employers implementing any of these changes must adopt a plan amendment by December 31, 2021 and may apply them retroactively to January 1, 2020.

Taxpayer Certainty and Disaster Tax Relief Act of 2020

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 in December 2020 as part of an omnibus package addressing COVID-19 relief and other matters. The act allowed

employers offering health and dependent care FSAs to adopt temporary rules to provide employees more flexibility in using their benefits and prevent them from losing their unused funds ([P.L. 116-260, Div. EE § 214](#)).

Under the act, for both health and dependent care FSAs, employers may do the following:

1. allow participants to carry over FSA balances remaining at the end of the (a) 2020 plan year to the 2021 plan year and (b) 2021 plan year into the 2022 plan year,
2. extend grace periods to 12 months for plan years ending in 2021 and 2022, and
3. modify contributions on a prospective basis during a plan year ending in 2021 for any reason without regard to change of status events.

As under existing law, employers may not offer both a grace period and a rollover. Under the act, employers may also (1) allow employees who terminate health FSA participation in the 2020 or 2021 plan year to use their unspent balance through the end of the plan year and (2) increase the dependent care age limit for the 2020 plan year from 13 to 14, making care provided for 13-year-olds eligible for reimbursement.

The act authorized employers to adopt these rules immediately and apply them retroactively, but they must do so by the end of the next plan year after the year for which they adopt any changes (e.g., if changes are made for the 2020 plan year, the amendment must be adopted by the end of the 2021 plan year).

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