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California Adopts Confusing FSA Notification Requirement

California recently enacted AB 1554 which purportedly requires an employer to notify employees of any deadline to withdraw funds from a flexible spending arrangement ("FSA") before the end of the plan year. The law applies to health care FSAs, dependent care FSAs and adoption assistance FSAs. Employees must be notified by two different forms, only one of which can be electronic. The new law is effective January 1, 2020.

The requirement appears to be aimed at notifying employees whose FSA coverage terminates during the year, thereby triggering a shortened runout period based on such mid-year termination. However, the law does not indicate that notice must be provided at a termination of employment. In fact, the law does not indicate at all when the notification should be made, other than requiring the notice to be in two different forms.

Application to Health Care FSAs

Health care FSAs are self-insured employee welfare benefit plans under ERISA, and the new law should be preempted by ERISA because it impacts plan administration. (ERISA preemption would not be available to governmental plans.) Therefore, as the new law relates to health care FSAs, plan sponsors should not be required to comply. However, even if ERISA preemption did not apply, the application of the new law to health care FSAs is very narrow and plan sponsors will likely be able to comply without even issuing any new notices.

If health care FSA coverage terminates mid-year (e.g., termination of employment, change in employment status), a health care FSA will either impose a shortened time period for submitting runout claims or the regular calendar year runout period will apply. For example, if an employee terminates employment on May 30th, some health care FSAs require that claims incurred on or before May 30th must be filed within 60-90 days from that date. Because the new law targets a "deadline to withdraw funds . . . before the end of the plan year," this is exactly the situation that the new law appears to target.

Alternatively, other health care FSAs do not require claims to be filed within a certain period of time after a mid-year termination. For these plans, the health care FSA only imposes an annual requirement to file eligible claims within a certain period of time after the end of the plan year. For example, if an employee terminates employment on May 30th, the former health care FSA participant would have until 60-90

days after December 31st to file for reimbursement of claims incurred on or before May 30th. In this situation, funds are not required to be withdrawn before the end of the plan year, and therefore the new law should not apply. It is important to note that the new law focuses solely on the withdrawal of funds before the end of the plan year. Therefore, the typical health care FSA design that terminates "coverage" from and after a mid-year termination event would not by itself trigger the application of the new law.

Application to Dependent Care FSAs

Most dependent care FSA plans allow for a spend down of the dependent care FSA balance for the remainder of the year in situations where a dependent care FSA participant terminates coverage mid-year. Treasury regulations governing dependent care FSAs also allow a dependent care FSA to cover claims incurred after a mid-year termination and prior to the end of the plan year. Therefore, the new law would not apply to most dependent care FSAs, because most dependent care FSAs are not designed to require funds to be withdrawn before the end of a plan year.

Compliance Issues

As noted above, the new law should only apply to health care FSAs that impose a shortened claims runout period for mid-year health care FSA terminations, thereby triggering the two forms of notice. (This assumes that ERISA preemption does not apply.) However, because the new law does not indicate when the two forms of notice should be given, plan sponsors may already satisfy the notification requirement. The reason for this result is that the runout rules are always discussed in the Summary Plan Description which would satisfy as one of the forms of notice. The other form of notice could be satisfied by any other employee communication that contains the mid-year runout rules, including any of the following –

- Annual enrollment guide,
- Employee newsletter,
- Explanation of payment / benefits received from FSA claims administrator, or
- Description of the runout rules on an employee benefits website or website of the FSA claims administrator.

In addition to the above, if a health care FSA includes a shortened runout period for mid-year terminations, a plan sponsor could change the design to remove the shortened runout rule, thereby only requiring the annual runout period after the end of a plan year. Such a change would render compliance with the new law a moot point.