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Increased Limit for Dependent Care Assistance Programs: Traps for the Unwary

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Who Needs to Know

U.S. employers, particularly HR personnel.

Why It Matters

The American Rescue Plan Act of 2021 (ARPA), signed into law by President Biden on March 11, increases the amount employees can exclude from their 2021 gross taxable income for employer-provided dependent care assistance program (DCAP) benefits under Internal Revenue Code (Code) Section 129. Although this increase in the exclusion limit solves an issue for 2021 that arose because of extended grace period and carryover features that permit unused dependent care flexible spending account (DCFSA) amounts from 2020 to be used in 2021, it also can be used to allow employees to increase their pre-tax contribution elections to their 2021 DCFSA. The availability of this increased election creates a host of issues that should be understood by the employer before increased elections are permitted.

The American Rescue Plan Act of 2021 (ARPA), signed into law by President Biden on March 11, 2021, increases the amount employees can exclude from their 2021 gross taxable income for employer-provided dependent care assistance program (DCAP) benefits under Internal Revenue Code (Code) Section 129. Such benefits are often provided in the form of pre-tax employee contributions to a dependent care flexible spending account (DCFSA) through a Code Section 125 cafeteria plan.

Ordinarily, the amount that can be excluded for DCAP benefits is limited to $5,000 (or $2,500 for married individuals filing separately), subject to certain earned income limitations. For 2021, ARPA has increased that limit to $10,500 (or $5,250 for married individuals filing separately).

This increase in the amount of DCAP benefits that can be provided on a tax-free basis in 2021 is welcome news for employees whose dependent care needs and expenses have been impacted by the COVID-19 pandemic and seems straightforward on its face. However, there are several considerations associated with this income exclusion that employers and employees should be aware of, as described in detail below.

Background

Year of Exclusion

Under Code Section 129, DCAP benefits up to the applicable limit can be excluded from gross income for the year in which the dependent care services are provided, regardless of when payment or reimbursement for such services occurs.

Example: If an employee contributes $5,000 to a DCFSA in Year 1 and incurs $5,000 of eligible dependent care expenses in Year 1, but receives reimbursement for those expenses in January of Year 2, the $5,000 is excluded from the employee's gross income for Year 1 (the year in which the dependent care expenses were incurred) and not for Year 2 (the year in which the employee received reimbursement).

IRS Reporting

In Box 10 of Form W-2, employers must report the total amount of DCAP benefits provided to each employee in the taxable year for which the W-2 is issued. Any amount of DCAP benefits that exceeds the applicable limit that can be excluded from gross income (*e.g.,* $5,000 for 2020) must also be reported as taxable income in Boxes 1, 3, and 5 of the W-2.

Example: If an employer directly pays or reimburses $7,500 of dependent care expenses for an employee in Year 1, the employer would report $7,500 in Box 10 of the employee's W-2 for Year 1 and $2,500 in Boxes 1, 3, and 5 of the W-2.

When the only DCAP benefits provided are in the form of employee pre-tax contributions to a DCFSA, the employer reports the total amount contributed by the employee to the DCFSA during the year in Box 10 of the W-2, even if the employee has not yet received (or never receives) reimbursement of that full amount. Because employers should not permit employees to make contributions to a DCFSA in excess of the applicable exclusion limit, there generally would be no amount to report in Boxes 1, 3, or 5 of the W-2.

In addition to employers' W-2 Box 10 reporting obligations, employees must complete Form 2441 (Child and Dependent Care Expenses) and include that form with their Form 1040 for the year. Form 2441 includes a worksheet that employees complete to determine if any employer-provided DCAP benefits are taxable and report earned income amounts, as well as DCFSA amounts, that are forfeited or carried over to the next year for use during a grace period.

Impact of Grace Period

Prior to the increased flexibility afforded by recent COVID-19-related legislation as discussed below, a DCFSA could not have a carryover feature whereby unused amounts could be carried over for use in the next taxable year. Rather, a DCFSA could only have a grace period feature whereby unused amounts from one taxable year could be used to reimburse expenses incurred within the first 2½ months of the next taxable year.

When a DCFSA has a grace period, IRS guidance has confirmed that employers can continue to satisfy their reporting obligation by simply reporting the total amount of employee pre-tax contributions to the DCFSA in Box 10 of Form W-2 for the year, even if unused amounts from Year 1 will be available for use during the grace period in

Year 2. The impact of the grace period is reflected on Form 2441, which instructs employees to adjust the W-2 Box 10 amount for the tax year at issue by:

- adding any unused amounts from the previous year that were available for use during the grace period at the beginning of the current tax year; and

- subtracting any unused amounts from the current tax year that will be available for use during the grace period at the beginning of the next tax year.

Ultimately, as a result of the Form 2441 adjustments and calculations, unused DCFSA amounts from Year 1 that remain available for reimbursement of dependent care expenses incurred during a grace period in Year 2 count toward the maximum DCAP benefits that can be excluded from gross income in Year 2. If an employee elects to contribute the maximum amount permitted to the DCFSA for Year 2, uses that entire amount for expenses incurred in Year 2, and also uses the amount available from Year 1 for expenses incurred during the grace period in Year 2, then the employee will have to include in Year 2 taxable income the Year 1 amount used during the grace period in Year 2. Such an employee may be able to claim a dependent care tax credit (DCTC) for all or part of the excess amount that is taxable to the employee, subject to the DCTC eligibility rules.

Example: Under a DCFSA with a grace period, an employee elects to contribute $5,000 for Year 1, but only incurs $4,500 in eligible expenses in Year 1, leaving $500 available for reimbursement of dependent care expenses incurred during the grace period in Year 2. The employee elects to contribute $5,000 for Year 2 as well, and incurs $5,500 in eligible expenses in Year 2 (at least $500 of which were incurred during the grace period at the beginning of Year 2). On the employee's W-2 Box 10 for Year 1 and Year 2, the employer reports $5,000. On the employee's Form 2441 for Year 2, the employee adds the $500 from Year 1 that was used during the grace period at the beginning of Year 2 to the $5,000 contribution for Year 2. Assuming the employee's exclusion limit for Year 2 is $5,000, the employee must include the excess $500 in taxable income for Year 2 since the employee received $5,500 in reimbursements for expenses incurred in Year 2.

Consolidated Appropriations Act: FSA Relief

Under the Consolidated Appropriations Act, 2021 (CAA), signed into law on December 27, 2020, an employer can amend its DCFSA for 2020 and/or 2021 to either have (1) a 12-month grace period for amounts that remain unused at the end of each of those years or (2) a carryover feature whereby employees can carry over their unused amounts from each of those years for use during the subsequent year. If an employer implements either of these approaches, the result is essentially the same:

- an employee who wasn't able to use the entire amount contributed to a DCFSA in 2020 will have all of 2021 to use amounts remaining from 2020 for reimbursement of eligible expenses incurred in 2021; and/or

- an employee who isn't able to use the entire amount available under a DCFSA in 2021 will have all of 2022 to use amounts remaining from 2021 for reimbursement of eligible expenses incurred in 2022.

The CAA also allows employers to amend their cafeteria plan and DCFSA to allow employees to make prospective midyear election changes to their 2021 DCFSA pre-tax contribution elections for any reason (*i.e.,* employees can be permitted to change 2021 DCFSA pre-tax contribution elections even if they have not

experienced a change in status or other work/life event that is ordinarily required as the basis for a midyear election change).

American Rescue Plan Act: Increased DCAP Exclusion Limit

Putting all of this together, it seems that one of the main reasons for ARPA's increase to the DCAP exclusion limit for 2021 from $5,000 to $10,500 is so that unused DCFSA amounts from 2020 that are available and used in 2021 — either due to the CAA's 12-month grace period or carryover provision — don't become taxable to employees in 2021. Because DCAP benefits are excluded from gross income under Code Section 129 for the year in which the dependent care services are provided, absent ARPA's increased exclusion limit for 2021, unused DCFSA amounts from 2020 that are available and used in 2021 could end up being taxable for employees who make new 2021 DCFSA contributions and use those amounts for eligible expenses incurred in 2021.

Example: An employee elected to contribute $5,000 to a DCFSA with a grace period for 2020, but incurred and was reimbursed for only $1,000 of eligible dependent care expenses in 2020 due to COVID-19-related dependent care provider shutdowns. As permitted under the CAA, the employee's employer amended its DCFSA to provide an extended 12-month grace period for 2020. As a result, the unused $4,000 from the employee's 2020 DCFSA is available for reimbursement of eligible expenses incurred in 2021. During open enrollment for 2021, the employee again elected to contribute $5,000 to the DCFSA for 2021. The employee incurs $9,000 in eligible dependent care expenses in 2021, using up the entire amount available in his DCFSA ($4,000 from 2020 and $5,000 from 2021). Because ARPA increased the exclusion limit under Code Section 129 to $10,500, the employee can exclude the entire $9,000 reimbursed for expenses incurred in 2021 from gross income. Without ARPA's increased exclusion limit, the employee would have had to include the excess $4,000 in reimbursements above the regular $5,000 exclusion limit in 2021 taxable income.

Nothing in ARPA restricts the use of the increased exclusion limit to ensure that amounts from 2020 that are used in 2021 aren't taxable to employees. As a result, it seems that this ARPA provision could be paired with the CAA provision allowing prospective midyear election changes in 2021 for any reason, such that employers could permit employees to increase their 2021 DCFSA elections midyear up to the new $10,500 limit, regardless of any 2020 DCFSA elections, grace period, or carryover.

In addition, nothing in ARPA prevents employers from restricting 2021 DCFSA election changes so that the amount available at the end of 2020, plus the updated 2021 contribution election amount, does not exceed $10,500. However, there are several important considerations associated with ARPA's increased DCAP exclusion limit that both employers and employees should keep in mind.

Traps for the Unwary

Although the increased flexibility afforded by the CAA and the increased exclusion limit under ARPA are certainly welcome relief for many employees whose dependent care expenses have been impacted by the COVID-19 pandemic, employers should keep in mind and potentially alert employees to the following considerations so that employees can make informed elections and individual tax planning decisions.

- *2021 Midyear Election Changes*: When employees are deciding whether and to what extent to increase their DCFSA election for 2021 (if permitted by their employer), they should keep in mind any unused 2020 DCFSA

amounts that remain available for reimbursement of eligible dependent care expenses incurred in 2021 (due to an extended grace period or carryover provision adopted by the employer). In particular, employees should not increase their 2021 DCFSA elections to an amount that, when combined with the amount still available from 2020, exceeds the new $10,500 exclusion limit for 2021.

- *Nondiscrimination Requirements*: In determining whether to allow employees to increase their 2021 DCFSA elections midyear up to the new $10,500 limit, employers also should consider the Code Section 129 nondiscrimination requirements. Under those nondiscrimination requirements, which remain unchanged for 2021, DCAPs cannot discriminate in favor of highly compensated employees (HCEs). If a DCAP is discriminatory, the HCEs participating in the DCAP lose their exclusion from income under Code Section 129, and the amount of DCAP benefits an HCE receives for the year is included in the HCE's gross taxable income for the year. One of the nondiscrimination requirements under Code Section 129 that DCFSAs often have trouble satisfying is the 55% Average Benefits Test, which requires that the average benefits provided to non-HCEs equal at least 55% of the average benefits provided to HCEs. Because of higher utilization of DCFSAs by HCEs, employers frequently have to monitor and limit HCEs' DCFSA elections to ensure that the DCFSA passes the 55% Average Benefits Test. Employers who allow employees to increase their 2021 DCFSA elections midyear up to the new $10,500 limit may cause their DCFSA to become discriminatory for 2021, resulting in the loss of the entire income exclusion under Code Section 129 for all HCEs participating in the DCFSA. To mitigate this risk, an employer could limit the ability to increase 2021 DCFSA elections to non-HCEs only, though such an approach will result in incremental administrative complexity and may not be well received by employees. As a result, employers who have experienced difficulties in passing the DCAP nondiscrimination requirements in the past may ultimately decide not to allow employees to increase their 2021 DCFSA elections midyear up to the new $10,500 limit, in order to ensure their DCFSA continues to satisfy Code Section 129's nondiscrimination requirements and HCEs continue to be able to exclude their DCFSA benefits from gross taxable income.

- *2022 Exclusion Limit*: Thinking ahead to 2022, if the new higher exclusion limit under ARPA is not extended by future legislation to apply to 2022 as well, then any unused DCFSA amounts from 2021 that remain available for use in 2022 will be subject to the prior $5,000 limit (*i.e.,* any eligible expenses over $5,000 that are incurred and reimbursed from the DCFSA in 2022 would be taxable in 2022). Employers should keep an eye on this as the year unfolds and consider proactively communicating these tax consequences during open enrollment for 2022. If an employer chooses not to adopt a 12-month grace period or a carryover provision for its DCFSA for the 2021 plan year, and instead only maintains a 2½ month grace period into 2022, such a design will compress the time in which employees can use any DCFSA amounts remaining from 2021, making employees' election decisions with respect to the 2022 plan year more complex.

- *Employer Withholding and FICA Obligations*: Amounts contributed to a DCFSA are not subject to federal income tax withholding or FICA taxes if it's reasonable for the employer to believe that the employee can exclude such amounts from income under Code Section 129. However, if an employer knows that an employee has a large DCFSA amount from 2020 available for use in 2021, and allows the same employee to increase their 2021 DCFSA contribution election to the full new $10,500 limit, it may not be reasonable for the employer to believe that the employee will be able to exclude the entire 2020 and 2021 amounts from income under Code Section 129. As a result, the employer may have federal income tax and FICA tax withholding obligations with respect to the amount above the new higher limit for 2021. Although the employer's reasonable belief is a factual determination for which the IRS has not provided significant guidance, employers should give thought to this issue and make a good faith determination about how to handle it.

Given the complexities of this area and the interrelated provisions of the CAA and ARPA, employers should consult with experienced benefits counsel to discuss how best to navigate these issues.

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