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Tax Free Dependent Care Assistance Program Benefits: Fewer Traps for the Unwary

WRITTEN BY

Evelyn Small Traub | Emily D. Zimmer | Brianna Hourihan

Who Needs to Know

U.S. employers, particularly HR personnel

Why It Matters

On May 10, the Internal Revenue Service (IRS) issued Notice 2021-26, which states that unused employer-provided dependent care assistance program (DCAP) benefits from 2020 or 2021 that are used in the next year remain excludable from gross taxable income in the year used. This article follows up on our March 2021 article, "Increased Limit for Dependent Care Assistance Programs: Traps for the Unwary," which described considerations regarding the American Rescue Plan Act of 2021 (ARPA) increase in the amount employees can exclude from their 2021 gross taxable income for DCAP benefits under Internal Revenue Code (Code) Section 129. IRS Notice 2021-26 clarifies the interplay between the carryover and 12-month grace period provisions of the Consolidated Appropriations Act, 2021 (CAA) and the increased Code Section 129 exclusion limit set forth in the ARPA.

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As nearly every aspect of life has felt the impact of COVID-19, not even the taxation of dependent care benefits was spared from the pandemic's far reaching effects. In a nationwide effort to assist employees whose dependent care needs and expenses have been impacted by the pandemic, legislation has been enacted over the past six months that has added great flexibility to DCAPs under Code Section 129.

Background

By way of reminder, Code Section 129 allows DCAP benefits to 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), up to an applicable limit.

The Consolidated Appropriations Act, 2021 (CAA), enacted in December 2020, permits employers to allow unused DCAP benefits to be carried over from a plan year ending in 2020 to a plan year ending in 2021, and from a plan year ending in 2021 to a plan year ending in 2022. Alternatively, if any unused benefits remain in the DCAP, the CAA permits a DCAP to extend its grace period within which claims can be incurred to 12 months after the end of the plan year for plan years ending in 2021 or 2022. The CAA also allows employers to amend their cafeteria plan and dependent care flexible spending accounts (DCFSAs) to allow employees to make prospective midyear election changes to their 2021 DCFSA pre-tax contribution elections for any reason.

Three months after the CAA was signed into law, President Biden signed the American Rescue Plan Act of 2021 (ARPA) into law. For 2021, the ARPA increases the exclusion for DCAP benefits under Code Section 129 to $10,500 ($5,250 for married individuals filing separately). Prior to this increase, the standard exclusion amount under Code Section 129 was limited to $5,000 (or $2,500 for married individuals filing separately), subject to certain earned income limitations.

Although the increased flexibility provided by the DCAP-related provisions of the CAA and ARPA was appreciated by many employers and their employees, how the two laws' provisions work together was less than clear. Thankfully, the IRS shed some much-needed light on the interplay of the CAA and ARPA in recently published guidance.

Notice 2021-26

The IRS released Notice 2021-26 (Notice) on May 10. This new guidance assists employers in determining the amount of DCAP benefits that can be excluded from an employee's income given the DCAP-related provisions under the CAA and ARPA. In the Notice, the IRS states that unused DCAP benefits eligible for exclusion from income during the taxable year ending in 2020 or 2021 will remain eligible for exclusion from the participant's gross income if used in the next taxable year per the CAA's carryover or 12-month grace period provisions. Additionally, unused DCAP benefits will be disregarded for purposes of the application of the exclusion limit under Code Section 129 when they are carried over from a plan year ending in 2020 or 2021 or permitted to be used during a 12-month grace period.

Example: Assume an employee elects no DCFSA contributions for 2019 and then subsequently elects to contribute $5,000 to a DCFSA for 2020. If the employee does not incur any dependent care expenses during 2020, per the CAA, the employer can allow the employee to carry over this unused $5,000 DCFSA balance to 2021.

The CAA and ARPA also permit the employer to allow employees to increase their 2021 DCFSA contribution election up to the increased exclusion limit. Assume the employee maxes out her election up to the new ARPA limit and contributes $10,500 to her DCFSA for 2021. If, in 2021, the employee incurs $15,500 in eligible dependent care expenses and is reimbursed $15,500 by the DCFSA, the entirety of the $15,500 is excluded from the employee's gross income and taxable wages — $10,500 is excluded as 2021 benefits and $5,000 is excluded

as the carryover from 2020, per the Notice, since such amount would have been excludable if used in 2020.

Additionally, under the Notice, the IRS provided a detailed explanation and accompanying examples of the application of these principles to Code Section 125 cafeteria plans that have a non-calendar year plan year. The Notice may help employers with DCFSAs provided under such cafeteria plans with non-calendar year plan years to navigate their way through the CAA and ARPA.

Continued Caution

Although the Notice provided some clarity and transparency into the interplay of the DCAP provisions under the CAA and ARPA, employers still need to proceed with caution regarding the taxation of DCAP benefits. Particularly, employers still need to be cognizant of the following:

- ***Nondiscrimination Requirements*:** When deciding whether to permit employees to increase their 2021 DCFSA election to the higher $10,500 exclusion limit for 2021, the Code's nondiscrimination requirements need to be considered. As set forth in more detail in our earlier article, "Increased Limit for Dependent Care Assistance Programs: Traps for the Unwary," the nondiscrimination requirements of Code Section 129 require that DCFSAs satisfy the 55% Average Benefits Test. The 55% Average Benefits Test requires that the average benefits provided to non-highly compensated employees (non-HCEs) equal at least 55% of the average benefits provided to HCEs. Because HCEs are more likely than non-HCEs to utilize DCFSAs, it is imperative that employers continue to monitor DCFSA elections and, if needed, restrict HCEs' elections to ensure their DCFSA does not become discriminatory.

- ***Planning for 2022 and 2023*:** Both employers and employees will likely need to plan carefully as they consider DCFSA elections and benefits for 2022 and 2023. If the new higher exclusion limit under ARPA is not extended by future legislation to apply to years after 2021, then the prior $5,000 limit will apply again for 2022, 2023, and future years. Per the Notice, unused DCFSA amounts carried over from 2021 and used in 2022 remain excludable from income to the extent they would have been excluded from income if used in 2021. It seems this could result in up to $20,500 of eligible dependent care expenses incurred in 2022 that could be reimbursed from an employee's DCFSA and excluded from income for employees with maximum DCFSA contributions and carryovers from 2020 and 2021 of $15,500 who also contribute the maximum $5,000 in 2022. However, absent additional legislation or IRS guidance in the future, it seems any unused DCFSA amounts available at the end of 2022 that are used during a regular 2 ½ month grace period at the beginning of 2023 will be includable in the employee's gross taxable income for 2023 to the extent the total amount used in 2023 exceeds the 2023 exclusion limit of $5,000.

- ***Reimbursement of 2021 Dependent Care Expenses*:** Putting the Notice together with the IRS's earlier Notice 2021-15, if an employer allows employees to increase their 2021 DCFSA election to the higher $10,500 exclusion limit for 2021, the additional DCFSA contributions can be used to reimburse any eligible dependent care expenses incurred on or after January 1, 2021 through the end of the plan year ending in 2021. The employer does not have to limit the use of the additional contributions to expenses incurred on or after the date the employee requests their midyear election change. The increased salary reductions under a revised election

can only be applied prospectively (*e.,* the date that the higher contribution amount actually starts being withheld from pay has to be on or after the date that the employee makes their new higher election). But the additional amounts available after the revised election can be used for any eligible dependent care expenses incurred on or after January 1, 2021 through the end of the plan year ending in 2021.

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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