

EMPLOYEE BENEFITS



IRS Issues Guidance on the Taxation of Dependent Care Benefits

By Melanie N. Aska and Erek M. Sharp | May 14, 2021

On May 10, 2021, the IRS issued Notice 2021-26, which addresses the taxation of dependent care benefits, provided through a Code Section 129 dependent care assistance program (“DCAP”), available in taxable years ending in 2021 and 2022 due to the application of either the carryover or the extended grace period extension permitted by Section 214 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the “Act”), enacted on December 27, 2020, as Division EE of the Consolidated Appropriations Act, 2021 (“CAA”).

Notice 2021-26 clarifies that if these dependent care benefits would have been excluded from income if used during the preceding taxable year, that is, during the taxable year ending in 2020 (or 2021, as applicable), they would remain excludable from the employee’s gross income and would not be wages if used for dependent care benefits during the taxable years ending in 2021 and 2022.

Notice 2021-26 also clarifies that these dependent care benefits will not be taken into account when applying the Code Section 129 exclusion limit to other dependent care benefits available for the taxable years ending in 2021 and 2022. This is a change from how the Code Section 129 exclusion limit has been applied to grace period amounts in years prior to the CAA. In those years (and as a continuing general rule), reimbursements of dependent care benefits in excess of the Code Section 129 exclusion limit attributable to a grace period were taxable to recipients.

Finally, Notice 2021-26 also explains how the temporary increase in the Code Section 129 exclusion limit permitted by the American Rescue Plan Act (“ARP”), enacted on March 11, 2021, applies to DCAPs with non-calendar plan years.

Background

Dependent Care Assistance Programs – In General. Code Section 129 provides an exclusion from gross income of an employee for amounts paid or incurred by the employer for dependent care assistance benefits provided to the employee if the assistance is furnished pursuant to a DCAP described in Code Section 129. Code Section 129(a)(2) limits the dollar amount of dependent care assistance benefits that may be excluded from the employee’s gross income and wages with respect to dependent care assistance services provided during the employee’s taxable year (which typically is the calendar year). For 2020, the exclusion could not exceed \$5,000 (for an unmarried employee or for a married employee filing jointly) or \$2,500 (for a married employee filing separately).

DCAPs may be provided by a flexible spending arrangement (“FSA”) under a Code Section 125 cafeteria plan. Thus, an employee may contribute to the DCAP through salary reduction, and the DCAP may reimburse the employee for dependent care expenses incurred during the year. The reimbursements of dependent care expenses are excluded from the employee’s gross income and wages under Code Section 129. Reimbursements that are not excludable under Code Section 129 are includable in the employee’s gross income and wages.

The Code Section 129 exclusion limit applies to amounts paid or reimbursed for dependent care services provided during the employee's taxable year (which typically is the calendar year). Unused benefits in a DCAP may be used during an up-to-2½-month grace period following the end of the DCAP's plan year (which may be the calendar year or a non-calendar year). Prior to the CAA (and presumably, as a continuing general rule), if the sum of DCAP benefits used in the employee's taxable year (including unused DCAP benefits used during a grace period, or a portion of a grace period, that falls in the employee's taxable year) exceeds the Code Section 129 exclusion limit, however, the excess would be taxable to the employee.

Pre-CAA DCAP Rules Relating to Carryover and Grace Period Features. Under the law as in effect prior to the CAA (and presumably, as a continuing general rule), a DCAP offered under a Code Section 125 cafeteria plan may not have a "carryover" feature. That is, unused amounts remaining in a DCAP as of the end of a plan year may not be carried over into the next plan year and used to pay or reimburse a participant for dependent care expenses incurred during that next plan year. In addition, under the law as in effect prior to the CAA (and presumably, as a continuing general rule), a DCAP offered under a Code Section 125 cafeteria plan may have a limited "grace period" feature. That is, a participant may be permitted to apply unused amounts remaining in the DCAP at the end of the plan year to pay or reimburse dependent care expenses incurred during a grace period of up to 2½ months immediately following the end of the plan year.

Temporary Relief under the Act, Permitting Carryovers and Extended Grace Periods for a DCAP. As a result of COVID-19 and the unanticipated changes in the availability of dependent care caused by COVID-19, employees were, and are, more likely to have unused amounts remaining in DCAPs at the end of 2020 and 2021.

- *DCAP Carryover Feature.* The Act temporarily increases flexibility for a Code Section 125 cafeteria plan to provide, for the first time ever, a carryover of unused amounts remaining in a DCAP at the end of an applicable plan year to pay or reimburse dependent care expenses incurred in an applicable subsequent plan year. Specifically, the Act provides that, for plan years ending in 2020, a Code Section 125 cafeteria plan that includes a DCAP can permit participants to carry over all or any part of the unused DCAP benefits or contributions from that plan year to the plan year ending in 2021. The Act provides a similar carryover rule for plan years ending in 2021, permitting the carryover of all or any part of the unused DCAP benefits or contributions from that plan year to the plan year ending in 2022.
- *Extended Grace Periods for DCAPs.* The Act also temporarily provides flexibility for a Code Section 125 cafeteria plan to provide an extended grace period to apply unused amounts remaining in a DCAP to pay or reimburse dependent care expenses. Specifically, the Act provides that a Code Section 125 cafeteria plan that includes a DCAP may extend the grace period for a plan year ending in 2020 or 2021 to up to 12 months (instead of only 2½ months) after the end of that plan year, with respect to unused benefits or contributions remaining in the DCAP.

Consistent with pre-Act rules, an employer may not adopt both the Act's carryover feature and the Act's extended grace period feature for a particular plan year for a particular DCAP.

IRS Notice 2021-15. On February 28, 2021, the IRS issued Notice 2021-15, which among other things, clarified how the Act's temporary relief would apply to DCAPs. As noted above, the Act allows DCAPs to *either* (1) carry over unused amounts remaining in the DCAP 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, *or* (2) to extend the grace period, for a plan year ending in 2020 or 2021, to up to 12 months (instead of only 2½ months) after the end of the plan year with respect to unused benefits remaining in the DCAP.

IRS Notice 2021-15 provides guidance regarding the implementation of the temporary relief under the Act to allow unused DCAP benefits remaining at the end of a plan year to reimburse dependent care expenses incurred in the next plan year, either due to a carryover feature or to an extended grace period feature. Specifically, IRS Notice 2021-15 provides that if an employer adopts either the Act's temporary carryover relief or the Act's temporary extended grace period relief for its DCAP, the Code Section 129 exclusion limits apply to amounts contributed to a DCAP for a particular year, and not to amounts reimbursed or otherwise available for reimbursement from a DCAP in a particular year. Thus, unused DCAP amounts carried over from prior years or available during an extended grace period are not taken into account when applying the Code Section 129 exclusion limit to DCAP benefits in the following year.

The American Rescue Plan Act's Temporary Increase in the Code Section 129 Exclusion Limit on DCAP Benefits. The ARP, enacted on March 11, 2021, increases the Code Section 129 exclusion limit for employer-provided dependent care assistance to \$10,500 (for unmarried employees and for married employees filing jointly) or \$5,250 (for married employees filing separately) with respect to any taxable year beginning after December 31, 2020 and before January 1, 2022. Thus, for the typical employee, whose taxable year is the calendar year, the applicable increased exclusion limit (\$10,500 or \$5,250, as the case may be) would apply to the 2021 calendar taxable year.

As noted above, the ARP increases the Code Section 129 exclusion limit for employer-provided dependent care to \$10,500 (for unmarried employees and for married employees filing jointly) or \$5,250 (for a married employee filing separately) for the employee's 2021 *taxable year*, not for the *plan year*. Accordingly, in the case of a DCAP offered under a Code Section 125 cafeteria plan with a non-calendar plan year beginning in 2021 and ending in 2022, the increased Code Section 129 exclusion limit (\$10,500 or \$5,250, as applicable) will *not* apply to the reimbursement of dependent care expenses incurred during the 2022 portion of the plan year. Thus, reimbursement of more than \$5,000 (or \$2,500, as applicable) from the DCAP may result in a portion of the employee's contribution to the DCAP for the 2021 plan year that is used to reimburse dependent care expenses incurred during the 2022 taxable year becoming taxable upon reimbursement.

As noted above, IRS Notice 2021-15, issued on February 28, 2021, provides that, in applying the Act's temporary relief permitting carryovers and extended grace periods for DCAPs, unused amounts carried over from prior years or available during an extended grace period are *not* taken into account when applying the Code Section 129 exclusion limit to DCAP benefits in the following year.

IRS Notice 2021-26

IRS Notice 2021-26, issued on May 10, 2021, reflects the conclusion of the IRS and the Treasury Department that, inherent in the Act temporarily permitting unused DCAP amounts to be carried over to 2021 or 2022, or made available under an extended grace period, is that amounts that continue to be available are excluded from income if used by the participant for dependent care benefits. Consequently, IRS Notice 2021-26 clarifies that DCAP benefits that would have been excluded from a participant's gross income if used during the taxable year ending in 2020 or 2021, as applicable, remain eligible for exclusion from the participant's gross income and are disregarded when applying the Code Section 129 exclusion limit for the participant's subsequent taxable years when they are either carried over from a plan year ending in 2020 or 2021 or permitted to be used during an extended grace period.

IRS Notice 2021-26 provides several examples, illustrating the possible income tax consequences of a participant electing \$10,500 in DCAP benefits for a non-calendar plan year beginning in 2021 but ending in 2022. In all of the examples, the employee's taxable year is the calendar year and the employee is not a married individual filing separately (i.e., the employee is either unmarried or married filing jointly). The examples also assume that the DCAP and the Section 125 cafeteria plan under which the DCAP is offered comply with all applicable statutory requirements (including applicable nondiscrimination requirements) for all relevant periods. Finally, consistent with current law, the examples assume that the Code Section 129 exclusion limit for the employee's 2022 taxable year will revert to \$5,000 (for an employee who is unmarried or married filing jointly).

Example 1 – Calendar Plan Year. An employee, James, is covered by a calendar plan year Code Section 125 cafeteria plan that offers a DCAP benefit. James elects no DCAP benefits for the 2019 plan year. James elects to contribute \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during that plan year. Pursuant to the temporary carryover relief provided by the Act, the Code Section 125 cafeteria plan allows James to carry over the unused \$5,000 of DCAP benefits to the 2021 plan year. Pursuant to the ARP, James elects to contribute \$10,500 for DCAP benefits for the 2021 plan year.

James incurs \$15,500 in dependent care expenses in 2021 and is reimbursed \$15,500 by the DCAP. The \$15,500 is excluded from James's gross income and wages because \$10,500 is excluded as 2021 benefits and the remaining \$5,000 is attributable to a carryover permitted by the Act.

Example 2 – Non-Calendar Plan Year (July 1 to June 30). An employee, Laureen, is covered by a non-calendar plan year Code Section 125 cafeteria plan that offers a DCAP benefit. The Code Section 125 cafeteria plan has a July 1 to June 30 plan year. Laureen elects no DCAP benefits for the plan year beginning July 1, 2019. For the plan year beginning July 1, 2020, Laureen elects to contribute \$5,000 for

DCAP benefits, but she incurs no dependent care expenses during that plan year. Pursuant to the temporary carryover relief provided by the Act, the Code Section 125 cafeteria plan allows Lauren to carry over the unused \$5,000 of DCAP benefits to the plan year beginning July 1, 2021.

- **Taxable Year 2021 – Facts and Conclusion.** Pursuant to the ARP, Lauren elects to contribute \$10,500 for DCAP benefits for the plan year beginning July 1, 2021. Lauren has \$15,500 available for dependent care expenses for the plan year beginning July 1, 2021. Lauren incurs no dependent care expenses during the period from July 1, 2021 to December 31, 2021, and has \$15,500 of DCAP benefits available as of January 1, 2022. For the taxable year 2021, Lauren did not receive any DCAP benefits because no dependent care expenses eligible for reimbursement under the DCAP were incurred in 2021.
- **Taxable Year 2022 – Facts and Conclusion.** For the taxable year 2022, the Code Section 129 exclusion limit for DCAP benefits is \$5,000. Lauren incurs \$7,000 in dependent care expenses during the period from January 1, 2022 to June 30, 2022, and is reimbursed \$7,000 by the DCAP. The Code Section 125 cafeteria plan adopts a 2½-month grace period that is added to the end of the plan year beginning July 1, 2021, which allows Lauren to use the unused \$8,500 of DCAP benefits until September 15, 2022. Lauren elects to contribute \$5,000 for DCAP benefits for the plan year beginning July 1, 2022. She incurs \$8,500 in dependent care expenses during the period from July 1, 2022 through September 15, 2022, and incurs \$2,500 in dependent care expenses during the period from September 15, 2022 through December 31, 2022. She is reimbursed \$11,000 by the DCAP (\$8,500 plus \$2,500). Lauren therefore receives \$18,000 (\$7,000 plus \$11,000) in reimbursements of dependent care expenses during the 2022 taxable year. Of the \$18,000 received in calendar year 2022, \$10,000 is excluded from Lauren's gross income and wages because \$5,000 is excluded under the Code Section 129 exclusion limit for DCAP benefits for the taxable year 2022, and \$5,000 of the \$7,000 received from January 1, 2022 to June 30, 2022 is excluded because it is attributable to carryovers permitted under the Act that would have been excluded from gross income if used in the preceding taxable year (that is, attributable to carryovers to plan years ending before 2023). The remaining \$8,000 is included in Lauren's gross income and wages because it is not attributable to carryovers permitted under the Act.

Example 3 – Non-Calendar Plan Year (July 1 to June 30). An employee, Sam, is covered by a non-calendar plan year Code Section 125 cafeteria plan that offers a DCAP benefit. The Code Section 125 cafeteria plan has a July 1 to June 30 plan year. Sam elects no DCAP benefits for the plan year beginning July 1, 2020, and there are no unused amounts from prior plan years available.

- **Taxable Year 2021 – Facts and Conclusion.** Pursuant to the ARP, Sam elects to contribute \$10,500 for DCAP benefits for the plan year beginning July 1, 2021. Sam incurs \$5,000 in dependent care expenses during the period from July 1, 2021 to December 31, 2021, and receives \$5,000 in reimbursements during 2021. The \$5,000 is excluded from his gross income and wages pursuant to Code Section 129. Sam has \$5,000 of DCAP benefits available as of January 1, 2022.
- **Taxable Year 2022 – Facts and Conclusion.** For the taxable year 2022, the exclusion for DCAP benefits under Code Section 129 is \$5,000. Sam incurs \$5,500 in dependent care expenses during the period from January 1, 2022 through June 30, 2022, and is reimbursed \$5,500 by the DCAP. Sam elects to contribute \$5,000 for DCAP benefits for the plan year beginning July 1, 2022. He incurs \$2,500 in dependent care expenses during the period from July 1, 2022 to December 31, 2022, and is reimbursed \$2,500 by the DCAP. Sam receives a total of \$8,000 in reimbursements for DCAP benefits during 2022. Of the \$8,000 received in the 2022 taxable year, \$5,000 is excluded from Sam's gross income and wages under the exclusion for DCAP benefits under Code Section 129. The remaining \$3,000 received by Sam is included in his gross income and wages.

If you have any questions about IRS Notice 2021-26 or how that guidance might affect your business, please contact Melanie N. Aska, Counsel, at 617-457-4131 or maska@murthalaw.com or Erek M. Sharp, Partner, at 203-772-7772 or esharp@murthalaw.com.