



COMPLIANCE ALERT

IRS PROVIDES CLARIFICATION FOR DCAPS IN 2021 AND 2022

Issue Date: May 2021

The Internal Revenue Service (IRS) released Notice 2021-26 clarifying what amounts may be reimbursed under a dependent care assistance program (DCAP) on a tax-favored basis in 2021 and 2022. The additional flexibility in recent legislation to allow carryovers and extended grace periods, as well as the increased contribution limit of \$10,500 for the 2021 calendar year, left some confusion as to exactly how much could be reimbursed on a tax-favored basis during affected DCAP plan years. The notice, which includes several examples, confirms that amounts available in 2021 and 2022 due to a carryover or extended grace period will not count toward the \$10,500 limit in 2021 or the expected \$5,000 limit in 2022.

IRS Notice 2021-26 can be found here - <https://www.irs.gov/pub/irs-drop/n-21-26.pdf>

BACKGROUND

The general rule for DCAPs is that employees may be reimbursed up to \$5,000 per calendar year (or up to \$2,500 for individual who are married but filing separately) without having to include it in their taxable income. If the employee has money left over at the end of the plan year and takes advantage of a 2 ½ month grace period, any amount reimbursed above \$5,000 during the calendar year must be included in taxable income.

With this general rule in place, employers were unsure how to handle the taxation of DCAP reimbursements during 2021 and 2022 due to the following provisions added by recent COVID-related relief legislation.

Carryover or Extended Grace Period for Plan Years Ending in 2020 or 2021

In accordance with the Consolidated Appropriations Act of 2021 (CAA), employers may choose, but are not required, to adopt one of the following for DCAPs for plan years ending in 2020 or 2021:

- + A carryover of any unused DCAP balance to the next plan year; OR
- + A grace period of up to 12 months (rather than 2 ½ months) to continue incurring expenses toward the unused DCAP balance.

A DCAP may offer a carryover or an extended grace period for plan years ending in 2020 or 2021, but not both. While both options may offer the ability for participants to use the prior year's unused balance into the next plan year, a grace period will make the unused balance available to those who are no longer participants, while a carryover is generally only available to those who are still participating in the subsequent plan year.

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Increased DCAP Contribution Limits for 2021

For the 2021 calendar year, the American Rescue Plan Act of 2021 (ARP) increased the amount which may be contributed through a DCAP from \$5,000 to \$10,500 (or from \$2,500 to \$5,250 for individuals who are married but filing separately). Employers have the option, but are not required, to increase the election amount on plans they sponsor. Employers need to amend their DCAP plan by the end of the affected plan year to allow for this increased amount.

IRS CLARIFICATION ON DCAP TAXATION FOR 2021 AND 2022

IRS Notice 2021-26 provides an exception to the general rule for leftover amounts from a previous plan year that continue to be available due to a carryover or extended grace period. For the 2021 and 2022 calendar year, unused amounts from the previous plan year that continue to be available due to a carryover or extended grace period (as permitted by the CAA), will NOT count toward the annual maximum that may be reimbursed by the DCAP on a tax-favored basis. So, for example, in 2021, individuals may contribute and be reimbursed for up to \$10,500 in qualifying daycare expenses without having to include it in taxable income in addition to any amounts available for reimbursement due to a carryover or grace period applicable to the previous plan year. Similarly, in 2022, individuals may contribute and be reimbursed up to \$5,000 in addition to any amounts available for reimbursement due to a carryover or grace period applicable to the previous plan year.

See the following example from the notice for a calendar year DCAP:

An employee is covered by a calendar year \$125 cafeteria plan that offers a DCAP benefit. The employee elects no DCAP benefits for the 2019 plan year. The employee elects to contribute \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the plan year. Pursuant to §214 of the Act, the \$125 cafeteria plan allows the employee to carry over the unused \$5,000 of DCAP benefits to the 2021 plan year. The employee elects to contribute \$10,500 for DCAP benefits for the 2021 plan year. The employee incurs \$15,500 in dependent care expenses in 2021 and is reimbursed \$15,500 by the DCAP. The \$15,500 is excluded from the employee's gross income and wages because \$10,500 is excluded as 2021 benefits and the remaining \$5,000 is attributable to a carryover permitted under §214 of the Act.

NOTE: The analysis is a bit more complicated for a non-calendar year plan since the annual limits apply on a calendar-year basis regardless of the DCAP plan year, but the same general exception applies for unused amounts that remain available due to a carryover or extended grace period. The notice includes two additional examples for employers with non-calendar year plans to consider.

CONSIDERATIONS FOR THE INCREASED DCAP CONTRIBUTION LIMIT FOR 2021

For employers still trying to decide whether to increase the 2021 contribution limit to \$10,500, there are a few things to consider even now that the taxation uncertainty has been resolved by the IRS notice.

First of all, increasing the contribution limit guarantees employees up to \$10,500 in tax-free reimbursement for qualifying daycare expenses during 2021 (plus any amounts allowed to be used from the previous plan year). However, keep in mind that even if the contribution limit is not increased, employees may be able to claim daycare expenses in excess of \$5,000 on their tax return as a dependent care tax credit (which is a different

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program than the DCAP). The dependent care tax credit, normally with limits of \$3,000 for a single child and \$6,000 for more than 1 child, was increased to \$8,000 for a single child and \$16,000 for more than one child for 2021. Employees may be able to claim expenses that were not submitted to the DCAP for reimbursement (since no double-dipping permitted) as a dependent care tax credit.

Second, for DCAP plans that already struggle to pass discrimination testing, especially the 55% average benefits test, increasing the contribution limits, especially for highly compensated individuals, may make the plan even less likely to pass. We are not aware of any specific relief for §129 nondiscrimination rules related to this increase. Therefore, just as in other years, if a plan is discovered by the IRS to fail discrimination testing, the IRS could tax the benefits received by the highly compensated individuals.

SUMMARY

For employers who have already implemented or are still considering adopting additional flexibility for the DCAP, either allowing for a carryover or extended grace period, or increasing the contribution limit for 2021, this IRS guidance is welcome news. Previous confusion around exactly what amount could be reimbursed by the DCAP during 2021 and 2022 on a tax-favored basis made some employers hesitant to implement any changes. Now employers can make such decisions with a better understanding of the tax impact on participating employees.

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