

# CLIENT ALERT

May 19, 2021

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## IRS CLARIFIES TREATMENT OF DEPENDENT CARE BENEFITS

By Cynthia A. Moore

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 – part of the Consolidated Appropriations Act (“CAA”) – allows an employer to amend its cafeteria plan to allow either an unlimited carryover or a 12-month grace period to apply under a dependent care flexible spending account (“dependent care FSA”) for plan years ending in 2020 or 2021. Further guidance on this provision was provided by the IRS in Notice 2021-15, as discussed [here](#) in our prior Client Alert.

Section 129 of the Internal Revenue Code (“Code”) generally allows an employee to receive \$5,000 in tax-free dependent care benefits in the individual’s taxable year (the calendar year.) Section 129 was amended by the American Rescue Plan Act of 2021 (“ARPA”) to increase the amount of tax-free benefits a taxpayer can receive for 2021 to \$10,500 (\$5,250 for a married employee who does not file a joint return). The ARPA amendment allows employees to amend their elections under a cafeteria plan to increase their salary reduction contributions to as high as \$10,500 for 2021 if permitted by the plan.

The interplay between the amendments made by the CAA and ARPA raised a number of questions. For example:

- If an employee carried over \$2,000 in dependent care benefits from 2020 to 2021 and made the maximum salary reduction contribution of \$10,500 in 2021, what is the maximum tax-free benefit in 2021, \$10,500 or \$12,500 (\$10,500 plus \$2,000 carried over from 2020)?
- How does the unlimited carryover or 12-month grace period (which applies to a plan year) coordinate with the increased exclusion of \$10,500, which applies on a calendar year basis?

IRS Notice 2021-26, published on May 10, 2021, provides welcome clarification on these issues. The IRS has concluded that the intent of these provisions is that an employee will not be taxed on reimbursements over the Section 129 threshold that are attributable to amounts carried over, or reimbursed during an extended grace period, in plan years ending in 2020 or 2021.

Following are several examples that illustrate the operation of the new IRS guidance.

### Calendar Year Plan Example – Maximum Carryover Permitted

- Amount elected in 2020: \$5,000
- Amount reimbursed in 2020: \$0
- Amount carried over to 2021: \$5,000
- Amount elected for 2021: \$10,500
- Amount reimbursed in 2021: \$15,500 (\$10,500 contributed in 2021 plus \$5,000 carried over from 2021)
- Amount excluded from income in 2021: \$15,500

### *Why?*

- \$10,500 is excluded under the amendment to Section 129 made by ARPA
- \$5,000 is excluded because it is a carryover permitted by the CAA

### Non-Calendar Year Plan Example #1 – Maximum Carryover Permitted Plan year: July 1 – June 30

#### a. Taxable Year 2021

- Amount elected for the 7/1/20-6/30/21 plan year: \$5,000
- Amount reimbursed in the 7/1/20-6/30/21 plan year: \$0
- Amount carried over to the plan year beginning 7/1/21: \$5,000
- Amount elected for the 7/1/21-6/30/22 plan year: \$10,500 (therefore, a total of \$15,500 is available for the plan year beginning 7/1/21)
- Amount reimbursed for the period of 7/1/21-12/31/21: \$0

#### b. Taxable Year 2022 (exclusion amount under Section 129 reverts to \$5,000; plan includes the 2 ½ month grace period)

- Amount reimbursed for the period of 1/1/22-6/30/22: \$7,000
- Amount reimbursed during the 2 ½ month grace period of 7/1/22-9/15/22: \$8,500
- Amount elected for the 7/1/22-6/30/23 plan year: \$5,000
- Amount reimbursed for the period of 9/15/22-12/31/22: \$2,500
- Total reimbursements during calendar year 2022: \$18,000 (\$7,000 + \$8,500 + \$2,500)
- Excludable amount for 2022: \$10,000
- Taxable amount for 2022: \$8,000

### *Why?*

- \$5,000 is excluded under the normal Section 129 rule for taxable year 2022
- \$5,000 of the \$7,000 received from 1/1/22-6/30/22 is excluded as a carryover from the plan year ending in 2021
- Reimbursements in excess of \$10,000 are taxable

### Non-Calendar Year Plan Example #2 – Maximum Carryover Permitted Plan year: July 1 – June 30

#### a. Taxable Year 2021

- Amount carried over from the plan year ending 6/30/21: \$0
- Amount elected for the 7/1/21-6/30/22 plan year: \$10,500
- Amount reimbursed during the period of 7/1/21-12/31/21: \$5,000
- Amount excluded from income in 2021: \$5,000

#### b. Taxable Year 2022

- Remaining balance as of 1/1/22: \$5,500 (\$10,500 elected - \$5,000 in reimbursements received)
- Amount reimbursed 1/1/22-6/30/22: \$5,500
- Amount elected for the 7/1/22-6/30/23 plan year: \$5,000
- Amount reimbursed for the period of 7/1/22-12/31/22: \$2,500
- Total reimbursements received in 2022: \$8,000 (\$5,500 + \$2,500)
- Excludable amount for 2022: \$5,000
- Taxable amount for 2022: \$3,000

### Why?

- The maximum amount excludable in 2022 is \$5,000
- There are no benefits that carried over from the prior plan year. The balance of \$5,500 as of January 1, 2022 is the remaining amount elected for the plan year beginning July 1, 2021, and is not a carryover.

### Reporting by the Employer

We presume that an employer will report the amount of dependent care benefits under Notice 2005-61, which was issued after the IRS first permitted the 2 ½ month grace period for a dependent care FSA. Under that guidance, an employer reports the elected salary reduction amount under the cafeteria plan for the taxable year in Box 10 of Form W-2 and ignores the amount reimbursed to an employee, either during the plan year or during a grace period.

### Reporting by the Employee

We presume that the IRS will update Form 2441 to allow an employee to report, for 2021, a maximum exclusion of \$15,500 (\$10,500 maximum exclusion permitted by Section 129 plus a \$5,000 carryover.)

Note that there could be a mismatch between the amount reported by the employer as a salary reduction amount on Form W-2 and the amount of benefits received.

Employees who participate in a non-calendar year plan will need to be particularly careful in tracking the amount of reimbursements received and determining whether they are attributable to an amount carried over from 2021 to 2022 (or reimbursed during a 12-month grace period).

### Takeaways

Employers should communicate their plan design decisions to participants and remind them to carefully consider the amount of dependent care FSA benefits elected. Participants in non-calendar year plans, in particular, should be aware that some of their pre-tax benefits could be converted to taxable income in 2022.

Those plan design decisions include:

- Whether to allow an unlimited carryover or a 12-month grace period for plan years ending in 2020 or 2021
- Whether to permit employees to increase their elections to \$10,500 for 2021
- Whether election changes will be permitted without regard to whether a status change has occurred and, if so, whether the employer wants to place any limits on those election changes
- Whether to increase the age limit for a dependent child from age 13 to age 14 for plan years for which the annual enrollment was on or before January 31, 2020, and amounts carried over from that plan year, as permitted by the CAA

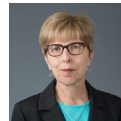
- If an employee enrolls in a dependent care FSA mid-year, whether the employee may be reimbursed for expenses incurred at any time during the plan year
- If an employee revokes his/her election during the plan year, whether the employee can be reimbursed for expenses incurred only during the period of coverage, or whether the employee can be reimbursed for expenses incurred for the balance of the plan year under the "spend-down" rule

If you have any questions about the changes affecting dependent care FSAs, please contact Cynthia A. Moore or any other member of Dickinson Wright's Employee Benefits and Executive Compensation Group. Cyndi can be reached at (248) 433-7295 or [cmoore@dickinsonwright.com](mailto:cmoore@dickinsonwright.com).

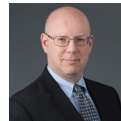
### KEY CONTACTS



**Cynthia A. Moore** is a Division Director in Dickinson Wright's Troy office. She can be reached at 248.433.7295 or [cmoore@dickinsonwright.com](mailto:cmoore@dickinsonwright.com).



**Deborah L. Grace** is a Member in Dickinson Wright's Troy office. She can be reached at 248.433.7217 or [dgrace@dickinsonwright.com](mailto:dgrace@dickinsonwright.com).



**Jordan S. Schreier** is Employee Benefits Practice Group Chair in Dickinson Wright's Ann Arbor office. He can be reached at 734.623.1945 or [jschreier@dickinsonwright.com](mailto:jschreier@dickinsonwright.com).



**Roberta P. Granadier** is Of Counsel in Dickinson Wright's Troy office. She can be reached at 248.433.7552 or [rgranadier@dickinsonwright.com](mailto:rgranadier@dickinsonwright.com).



**Eric W. Gregory** is a Member in Dickinson Wright's Troy office. He can be reached at 248.433.7669 or [egregory@dickinsonwright.com](mailto:egregory@dickinsonwright.com).