



COMPLIANCE ALERT



EMPLOYEE BENEFITS | JUNE 7, 2021

IRS Provides Additional Guidance on COVID-19-Related DCAP Relief

On May 10, 2021, the IRS released [Notice 2021-26](#), which provides additional guidance on relief authorized under in the [Consolidated Appropriations Act, 2021](#) (CAA), the [American Rescue Plan Act](#) (ARPA), and previous IRS guidance issued in [Notice 2021-15](#). Specifically, IRS Notice 2021-26 clarifies the maximum amount that can be excluded from an individual's gross income for dependent care expense reimbursements in 2021 and 2022 under a dependent care FSA / dependent care assistance program (DCAP) when the plan is using the extended grace period or carryover pursuant to the CAA. The new guidance permits individuals to take full advantage of both: (a) any extended carryover or grace period relief under the CAA; and (b) the increased maximum limit under Section 129 of the Code (from \$5,000 to \$10,500, or \$2,500 to \$5,250 for married couples filing separately) authorized under ARPA for 2021, if permitted under the employer's plan. As a result, individuals may receive up to \$15,500 in non-taxable reimbursements under a DCAP in 2021, if it meets all applicable nondiscrimination requirements.

The guidance is discussed in more detail below.

Background

As we previously reported, the CAA authorizes employers to amend their cafeteria plans to allow DCAPs to either carry over all unused funds 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 extend its grace period for a plan year ending in 2020 or 2021 to 12 months after the end of the plan year (versus the normal 2.5 months). Notice 2021-15 provided that if an employer adopted either the extended grace period or carryover relief, then the annual limits in §129 of the Code apply to amounts contributed to a DCAP for a particular year, and not to amounts reimbursed or otherwise available for reimbursement from DCAP in a particular plan or calendar year.

Per the IRS, this meant any unused amounts carried over from prior years or available during an extended grace period are excluded when determining the annual limit applicable for the following year. Thereafter, Congress passed ARPA, which amended §129 of the Code to increase the exclusion for qualified dependent care expenses to \$10,500 (\$5,250 for married couples filing separately) for calendar year 2021. Employers who choose to adopt the temporary \$10,500 exclusion limit must amend their plans before the last day of the plan year for which the amendment is effective, which would be December 31, 2021 for calendar year plans.

The IRS' New Guidance

Calendar Year Plans

Notice 2021-26 clarifies that if an employer adopts the extended carryover or grace period under the CAA and allows individuals to exclude up to \$10,500 (\$5,250 for married couples filing separately) in 2021 per ARPA, then:

- Any DCAP expenses eligible for exclusion from a participant's gross income are disregarded for purposes of application of the limits for the subsequent taxable years of the employee when they are carried over from the 2020 plan year or permitted to be used pursuant to an extended grace period, and
- Individual employees may exclude from income up to \$15,500 in qualified dependent care reimbursements for the plan year (which is comprised of \$5,000 from a grace period or carry-over from 2020 plus \$10,500 contributed in 2021).

The IRS provides the following example for a calendar year plan:

An employer adopts the carryover relief under the CAA. An employee elected to contribute \$5,000 to his DCAP for the 2020 plan year but incurred no dependent care expenses during the plan year and, therefore, carried over \$5,000 to the 2021 plan year. The employer amends the plan to allow employees to contribute up to \$10,500 for DCAP benefits for the 2021 plan year, and the employee elects the full \$10,500. 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 the CAA.

Non-Calendar Year Plans

While the above is relatively straightforward for calendar year plans, the relief is not as simple for non-calendar year plans. Employees are able to enjoy the full extent of any carryover or extended grace period relief under the CAA; however, if employers intend to amend their plans to allow employees to increase their elections for the plan year beginning in

2021 from \$5,000 to \$10,500, they are urged to proceed with caution. Because ARPA limits the \$10,500 exclusion to calendar year 2021, Notice 2021-26 clarifies that the increased exclusion amount will not apply to reimbursement of expenses incurred during the portion of the plan year falling in 2022.

Ultimately this limits the maximum reimbursement excludable from an employee's income for calendar year 2022 in one of two ways:

1. If the employer adopted the carryover or extended grace period relief provided under the CAA for the plan year beginning in 2020 and ending in 2021, then during the 2022 calendar year, employees may have the full use of the carryover or grace period for any unused amounts contributed as of the end of the 2020 plan year. They may also exclude up to \$5,000 reimbursed during the 2022 calendar year from funds contributed for the plan years beginning in 2021 or 2022. Thus, up to \$10,000 in dependent care reimbursements may be excluded from the employee's income during the 2022 calendar year. See example 2 below for an explanation of how this works.
2. If the employer does not adopt the extended carryover or grace period relief provided under the CAA, then any DCAP reimbursement in excess of \$5,000 made during calendar year 2022 would become taxable upon reimbursement. Example 1 below demonstrates how this works.

Example 1: If an employer adopts the \$10,500 limit for the plan year beginning July 1, 2021, and an employee elects to contribute to their DCAP for the first time (i.e., there is no carryover from a prior plan year), then if the employee incurs \$5,000 in dependent care expenses during the period from July 1, 2021, to December 31, 2021, the employee has \$5,500 of DCAP benefits available as of January 1, 2022 (once contributed). \$5,000 would be excluded from income for the 2021 tax year and \$5,500 would remain eligible for reimbursement from January 1, 2022 through June 30, 2022. For the plan year beginning July 1, 2022, the employee can elect up to \$5,000. If the employee incurs \$5,500 in dependent care expenses during the period from January 1, 2022, through June 30, 2022, elects to contribute an additional \$5,000 for the plan year beginning July 1, 2022, and incurs an additional

\$2,500 in dependent care expenses between July 1, 2022 and December 31, 2022 (for a total of \$8,000 incurred in 2022), then only \$5,000 is excluded from the employee's gross income and wages under § 129 of the Code. Therefore, the remaining \$3,000 received by the employee is included in the employee's tax year 2022 gross income and wages.

Example 2: If, on the other hand, (1) an employer adopts the extended carryover or grace period under the CAA for the 2020 plan year and the \$10,500 limit for the 2021 plan year, (2) an employee carries over \$5,000 from the 2020 plan year (the plan year ending on June 30, 2021) and elects the full \$10,500 for the plan year beginning July 1, 2021, and (3) the employee does not incur any dependent care expenses until January 1, 2022, then the employee could be reimbursed up to \$10,000 in calendar year 2022: \$5,000 due to any carryover from the plan year ending on June 30, 2021; and \$5,000 from any elections made that would be reimbursed in 2022 (such as from the period of January 1, 2022 through June 30, 2022 for the 2021 plan year or July 1, 2022 through December 31, 2022 for the 2022 plan year). However, if the employee incurs \$10,500 in dependent care expenses for the 2021 plan year between January 1, 2022 and June 30, 2022, \$500 would be included in the employee's tax year 2022 gross income and wages. Further, if the employee makes a new election of \$5,000 for the 2022 plan year and incurs \$2,500 in dependent care expenses between July 1, 2022 and December 31, 2022, then \$3,000 would be included in the employee's tax year 2022 gross income and wages.

Therefore, employers with non-calendar year plans are urged to consider these implications when adopting relief for employees and to ensure employees understand these limitations so they are not surprised at a later date.

What Does This Mean For Employers?

Ultimately, we urge caution for any employer who chooses to adopt the \$10,500 limit permitted under the ARPA, as the IRS has been very clear that nondiscrimination rules apply. Nondiscrimination testing for DCAPs is often difficult for plans to pass; however, introducing a limit that is more than double

the normal limit will likely only serve to exacerbate this issue, as generally only highly compensated employees would be able to set aside up to \$10,500 for dependent care expenses. Furthermore, as set forth above, if the employer has a non-calendar year plan, the applicability of ARPA, CAA, and Notice 2021-26 relief may result in unintended or unexpected taxable income issues for employees. Employers should evaluate these risks for their plans and work with counsel when adopting any plan amendments.

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