

Dependent Care Assistance Plan COVID-Related Carryover and Tax Relief

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According to the *law of unintended consequences*, decisions and actions always cause unforeseen effects. One of the many unintended consequences of the COVID-19 lockdowns is that many parents and guardians haven't had to pay nearly as much for daycare in 2020 and 2021 as planned, because they've had to keep their young children home.



On its surface, paying less for daycare seems like a good thing – offsetting the inconvenience and burden of having to work at home and care for the children. However, parents and their employers who contributed thousands of dollars to *dependent care assistant plans (DCAPs)* are understandably concerned and confused about what will happen to that money.

DCAPs have contribution limits, use-it-or-lose-it deadlines, and limits on the amount that can be withdrawn and used each year tax-free. Parents and employers carefully calculate their contributions each year to maximize their tax savings while at the same time avoid the possibility of contributing more than they'll use and losing the excess.

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The COVID-19 lockdowns reduced childcare expenses for many parents, resulting in large excess contributions in DCAP accounts. Luckily, government agencies have provided relief to resolve the issue, but now employers and employees are scrambling to take advantage of the relief and understand the new rules, which is the focus of this singlette.

Dependent Care Assistant Plan (DCAP) Basics

A DCAP or dependent care *flexible spending account* (FSA) is an employee benefit plan that provides tax relief to help employees pay for the care of a qualifying dependent. The Internal Revenue Service (IRS) regulations that govern DCAPs (pre-COVID relief) include the following:

- The qualifying dependent must be 12 years old or younger and live with the employee. Someone 13 years or older qualifies if that person is physically or mentally incapable of self-care and regularly spends at least eight hours a day in the employee's household.
- Employees can be reimbursed for eligible dependent care expenses so that the employee or employee's spouse may work, look for work, or attend school full time. Qualified dependent care expenses include payments for the following:
 - Daycare
 - Preschool or nursery school
 - Summer day camp
 - Babysitting or nanny (the sitter can be a relative you pay)
- The employer sets the minimum and maximum contribution limits, but the IRS limits the amount that can be used tax-free to \$5,000 per year (\$2,500 per parent if married filing separately). Any amount withdrawn for childcare in excess of \$5,000 per year is taxable income.
- DCAP funds are available only as they accrue from payroll deductions.
- All DCAP contributions made during the plan year must be used during the plan year. However, the plan may provide a grace period to allow unused funds at the end of a plan year to be used to pay expenses during the first 2.5 months of the following plan year.
- Any unclaimed DCAP funds remaining at the end of the benefit plan year (and any grace period) are forfeited and can't be rolled over into the following year.
- DCAP elections are irrevocable, except for certain changes in marital status, number of dependents, or employment status.

CAA Relief Provisions

To help parents and other qualified caregivers avoid forfeiting unused DCAP contributions

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as a result of COVID, the Consolidated Appropriations Act of 2021 (CAA), provides the following relief:

- Employers may amend cafeteria plans to allow employees to carry over unused DCAP benefits from the 2020 plan year to the plan year ending in 2021 and from the 2021 plan year to the plan year ending in 2022.
- Alternatively, employers may extend the DCAP grace period to up to 12 months after the end of the plan year.
- Unused contributions remaining at the end of the 2020 or 2021 plan year (including any grace period) may be used in the next plan year for a child who attained age 13 during the plan year (until the child turns age 14) or for another child who turns age 13 during the following plan year.
- Employers may amend their plans to allow employees to make midyear DCAP election changes to prospectively revoke an election, make an initial election, or increase or decrease an existing election.
- Amendments may be made retroactively, as long as the amendment is adopted by the last day of the calendar year following the plan year it's implemented, and the plan is operated according to the terms of the amendment as of its effective date. So, to be effective for a 2020 calendar year plan, an amendment must be adopted by 12/31/21.

For additional information on the CAA relief provisions, see [IRS Notice 2021-15](#) (note: link opens a PDF file).

ARPA Relief Provisions

With the CAA relief provisions, employees may accumulate large DCAP balances available for reimbursement in 2021. To help prevent them from forfeiting that money or being taxed on disbursements in excess of \$5,000, the American Rescue Plan Act of 2021 (ARPA) provides additional relief:

- ARPA temporarily increases the DCAP exclusion limit for calendar-year 2021 to \$10,500 (\$5,250 for married filing separately). To incorporate the increased limit, plans may be amended retroactively as long as the amendment is adopted by the last day of the plan year it's effective, and the plan is operated accordingly.
- Unused DCAP benefits carried over from a plan year ending in 2020 or 2021, or available during an extended grace period, remain excludable from gross income for 2021 or 2022, as long as the amounts are within the exclusion limit in the year contributed to the plan. For example, if an employee has a DCAP balance of \$15,500 in 2021 (\$5,000 carried over from 2020 + \$10,500 contributed for 2021), they can be reimbursed for the entire balance tax-free, assuming they incur \$15,500 in qualified dependent care expenses in 2021.

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Note: Barring an increased exclusion limit for 2022, any unused 2021 DCAP amounts that remain available for reimbursement in 2022 will be subject to the \$5,000 exclusion limit. So, any dependent care expenses over \$5,000 incurred and reimbursed in 2022 would be taxable income to the employee for 2022. We'll keep an eye out this year for any changes to these tax consequences.

DCAP relief is good news for both employers and employees – those who manage these valuable tax-saving plans and those who participate in them. Employers who were hesitant to implement the increased exclusion amount for 2021 due to the uncertainty of the tax consequences, can now move forward with confidence and clarity. What's important is that employers move quickly to implement changes before year's end, so that employees can reap the full benefits.

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