

IRS Notice 2021-26 Clarifies Taxation of Dependent Care Assistance Programs

by [Karen K. Hartford](#) on May 20, 2021

On May 10, 2021, the IRS issued [Notice 2021-26](#), which provides guidance regarding the taxation of dependent care assistance benefits provided through a Code Section 125 cafeteria plan, available in tax years ending in 2021 and 2022 due to the application of certain temporary pandemic relief provisions relating to the carry-over of unused balances from one plan year to the next and extended grace periods for incurring expenses. For calendar year plans, the guidance is all good news; non-calendar year plans, however, should proceed with caution.

The disruption caused by the COVID-19 pandemic left many individuals who elected dependent care benefits through their employer's dependent care assistance program ("DCAP") unable to use the funds in their accounts in 2020 and 2021--either because parents and children were home and, therefore, had no need for dependent care or because of daycare closures. Recognizing this, Congress introduced flexibility to change DCAP elections mid-year, but as with many tax-advantaged benefits, a small change to one area of the Internal Revenue Code has ripple effects on other areas of the Code.

Background—the “Ordinary Rules”

Code Section 129 allows an exclusion from gross income for dependent care expenses provided through a DCAP. Ordinarily, the exclusion is limited to \$5,000 for single individuals or those married, filing jointly, and \$2,500 for those married, filing separately. It is important to understand that the income exclusion applies to the individual's tax year (*i.e.*, typically the calendar year).

One characteristic of the tax-advantaged DCAP is that unused funds generally must be forfeited at the end of the plan year (the “use-it-or-lose-it” rule). IRS Notice 2005-42 introduced an optional “grace period” immediately following the end of the plan year during which unused DCAP benefits can be used to reimburse eligible dependent care expenses incurred during such grace period. Pursuant to Notice 2005-42, the grace period cannot extend beyond the fifteenth day of the third calendar month following the end of the plan year to which it applies (the “2 and a half month rule”). Note that because the Code Section 129 gross income exclusion applies on a calendar year basis, if the sum of DCAP benefits used in the taxable year plus the unused DCAP benefits used during a grace period exceeds the \$5,000 (or \$2,500) limit under Code Section 129, the excess is taxable. Stated another way: while the two and a half month grace period has the effect of saving unused funds from forfeiture, it does not ordinarily

save such funds from taxation if the total amount reimbursed in the taxable year exceeds the \$5,000 (or \$2,500) income exclusion amount.

Pandemic Relief

Section 214 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the “Act”), enacted December 27, 2020, allows DCAPs—for the first time ever—to carry over unused benefits from plan years ending in 2020 to the plan year ending in 2021 and from plan years ending in 2021 to the plan year ending in 2022. As an alternative, Section 214 of the Act allows a DCAP to extend its 2020 and/or 2021 grace period for up to 12 months (instead of just two and a half months) following the end of the plan year to which it applies (*i.e.*, up to 12/31/21 and/or 12/31/22 for calendar year plans).

While Section 214 of the Act permitted new flexibility to use unused DCAP funds in future years, it did not increase the Code Section 129 income tax exclusion. Thankfully, Congress later enacted Section 9632 of the American Rescue Plan Act of 2021 (ARPA), increasing the exclusion—for the 2021 taxable year only—to \$10,500 for single individuals and those married, filing jointly, and \$5,250 for those married, filing separately.

Also noteworthy, IRS Notice 2021-15, issued February 18, 2021, provides that “unused [DCAP benefit] amounts carried over from prior years or available during an extended period for incurring claims are not taken into account in determining the annual limit applicable for the following year,” thereby clarifying that DCAP participants may continue to make contributions up to the maximum annual permissible plan limit even if they had carried over unused funds or are benefiting from an extended grace period.

IRS Notice 2021-26

IRS Notice 2021-26 addresses another piece of the puzzle by stating that for taxable years ending in 2021 and 2022, all funds in a DCAP resulting from the new carryover provision or an extended grace period will remain excludable from gross income and are not “wages” of the employee. Specifically, the Notice provides that “DCAP benefits that would have been excluded from 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 for purposes of application of the limits for the subsequent taxable years of the employee when they are carried over from a plan year ending in 2020 or 2021, or permitted to be used pursuant to an extended claims period.”

Overall, IRS Notice 2021-26 is welcome news: DCAP participants affected by the pandemic will not be faced with surprising tax consequences as the result of 2021’s temporarily increased exclusion amount or the carryover of unused funds or extended grace periods. As illustrated by the examples in the Notice, however, all of this works best in the context of a calendar year plan. Non-calendar year DCAPs (*e.g.*, a DCAP

with a July 1 to June 30 Plan Year), must continue to bear in mind that the ordinary Code Section 129 gross income exclusion operates on a calendar year basis. Thus, for calendar year 2022, participants will only be able to exclude \$5,000 from income and wages. As the Service stated best in Notice 2021-26, “in the case of a DCAP offered by a Section 125 cafeteria plan with a non-calendar plan year beginning in 2021 and ending in 2022, the increased exclusion amount will not apply to reimbursement of expenses incurred during the 2022 portion of the plan year. Thus, reimbursement of more than \$5,000 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 expenses incurred during the 2022 taxable year becoming taxable upon reimbursement.” In light of this complexity, non-calendar year plans (whose open enrollment may be fast-approaching), should strongly consider limiting DCAP contributions to \$5,000 for plan years ending in 2022.

The pace of change and agency guidance in the employee benefits area over the last year has been dizzying. Please contact any member of Verrill’s [Employee Benefits & Executive Compensation Group](#) with questions or for assistance in implementing changes to your cafeteria plan.



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