



HAYS COMPANIES

IRS Offers Clarity on Taxation Issues Related to 2021 and 2022 Dependent Care Assistance Program Participation

On May 10, 2021, the IRS released [Notice 2021-26](#), which offers clarifying guidance on certain tax issues related to employees' participation in dependent care assistance programs (DCAPs) during 2021 and 2022. Below is a summary of the clarifications and examples to help illustrate the practical effect of the new guidance.

Previously, unused DCAP funds were unavailable for carryover to a subsequent plan year but were allowed to be subject to a 2 ½ month grace period for incurring additional claims after the applicable plan year. However, to address the change in dependent care demand during the pandemic, the Consolidated Appropriations Act of 2020 (the "CAA") offered new flexible options for unused DCAP funds, allowing employers to amend their plans to allow DCAP participants to carryover unused funds from plan year 2020 to 2021 and plan year 2021 to 2022. Alternatively, employers could extend a DCAP grace period for a plan year ending in 2020 or 2021 up to a period of 12 months.

Unused DCAP funds made available in 2021 or 2022 due to a carryover or extended claims period are generally excludable:

Notice 2021-26 clarifies that if carried-over DCAP funds, or funds subject to an extended grace period, would have been excluded from a DCAP participant's income if used during the prior tax year (i.e., during the taxable year ending in 2020 or 2021), they remain excludable from gross income and are not wages of the employee for the tax years ending in 2021 and 2022.

Additionally, the notice clarifies that carried-over DCAP funds, or funds subject to an extended grace period, will not be subject to IRS Code § 129's dependent care tax exclusion limits for the taxable years ending in 2021 and 2022. This is irrespective of the American Rescue Plan Act of 2021's increased exclusion limit for DCAP funds from \$5,000 to \$10,500 (half that amount in the case of a married individual filing separately) for 2021.



Examples

Calendar Year Examples

EXAMPLE 1

An employee is covered by a calendar year DCAP. The employee elects \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the 2020 plan year. The employee carries over the unused \$5,000 of DCAP benefits to the 2021 plan year and elects \$10,500 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 fully excluded from the employee's gross income and wages because \$10,500 is excluded as 2021 benefits, and the remaining \$5,000 is excluded because it is attributable to a carryover permitted under the CCA of 2021 (which Notice 2021-26 clarifies would be excludable).

EXAMPLE 2

An employee is covered by a calendar year DCAP. The employee elects \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the 2020 plan year. The DCAP provides an extended 12-month claims period following the 2020 plan year. The employee elects \$10,500 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 excluded because it is attributable to an extended claims period permitted under the CAA of 2021 (which Notice 2021-26 clarifies would be excludable).

EXAMPLE 3

An employee is covered by a calendar year DCAP. The employee elects \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the plan year. The employee carries over the unused \$5,000 of DCAP benefits to the 2021 plan year and elects to contribute \$7,500 for the 2021 plan year. The employee incurs (and is reimbursed for) \$2,500 in dependent care expenses in 2021. The \$2,500 is excluded from the employee's gross income and wages.

The employee carries over the unused \$10,000 of DCAP benefits to the 2022 plan year and elects \$5,000 for the 2022 plan year. The employee incurs (and is reimbursed for) \$15,000 in dependent care expenses in 2022. The \$15,000 is excluded from the employee's gross income and wages because \$5,000 is excluded as 2022 benefits, and the remaining \$10,000 is excluded because it is attributable to a carryover permitted under the CAA of 2021 (which Notice 2021-26 clarifies would be excludable).

EXAMPLE 4

An employee is covered by a calendar year DCAP. The employee elects \$5,000 for DCAP benefits for the 2020 plan year, but incurs no dependent care expenses during the plan year. The DCAP includes a 2 ½ month standard grace period. The employee elects to contribute \$10,500 for the 2021 plan year. The employee incurs \$5,000 in dependent care expenses during the first 2 ½ months of 2021 (i.e., during the grace period) and a total of \$15,500 in dependent care expenses during 2021. The employee is reimbursed \$15,500 by the DCAP. It appears 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 excluded because it is attributable to an extended claims period permitted under the CAA of 2021.

Note: Notice 2021-26 does not specifically address how the tax exclusion works in 2021 and 2022 for plans with standard 2 ½-month grace periods. Such a grace period could be considered an extended claims period for purposes



Examples

Fiscal/Non-Calendar Year Examples



EXAMPLE 5

An employee is covered by a DCAP with a July 1 through June 30 plan year. The employee elects \$5,000 for DCAP benefits for the 2019-20 plan year but incurs no dependent care expenses during that plan year. The employee carries over the unused \$5,000 of DCAP benefits to the 2020-21 plan year and elects \$5,000 for the 2020-21 plan year. The employee incurs \$7,500 in dependent care expenses between 7/1/20 and 12/31/20 and is reimbursed \$7,500 by the DCAP. The \$7,500 is fully excluded from the employee's gross income and wages because \$5,000 is excluded as 2020 benefits, and the remaining \$2,500 is excluded because it is attributable to a carryover permitted under the CCA of 2021 (which Notice 2021-26 clarifies would be excludable).

EXAMPLE 6

An employee is covered by a DCAP with a July 1 through June 30 plan year. The employee elects \$5,000 for DCAP benefits for the 2020-21 plan year but incurs no dependent care expenses during the period of 7/1/20 through 12/31/20. The employee incurs \$2,500 in dependent care expenses between 1/1/21 and 6/30/21 and is reimbursed \$2,500 by the DCAP. The employee carries over the unused \$2,500 of DCAP benefits to the 2021-22 plan year and elects \$5,000 for the 2021-22 plan year. The employee incurs \$7,500 in dependent care expenses between 7/1/21 and 12/31/21 and is reimbursed \$7,500 by the DCAP for a total of \$10,000 in benefits for the 2021 tax year. The \$10,000 is fully excluded from the employee's gross income and wages because it is excluded as 2021 tax year benefits (under the special increased exclusion for 2021 under § 129 of the Code).

EXAMPLE 7

An employee is covered by a DCAP with a July 1 through June 30 plan year. The employee elects \$10,500 for DCAP benefits for the plan year beginning 7/1/21. The employee incurs \$5,250 in dependent care expenses during the period from 7/1/21, to 12/31/21 and receives \$5,250 in reimbursements during 2021. The \$5,250 is excluded from the employee's gross income and wages. The employee has \$5,250 of DCAP benefits available as of January 1, 2022.

For the tax year 2022, the exclusion for DCAP benefits under § 129 of the Code is \$5,000. The employee incurs \$5,250 in dependent care expenses during the period from 1/1/22 through 6/30/22, and is reimbursed \$5,250 by the DCAP. The employee elects to contribute \$5,000 for DCAP benefits for the plan year beginning 7/1/22. The employee incurs \$2,500 in dependent care expenses during the period from 7/1/22 to 12/31/22 and is reimbursed \$2,500 by the DCAP. The employee receives a total of \$7,750 in reimbursements for DCAP benefits during 2022. Of the \$7,750 received in the 2022 taxable year, \$5,000 is excluded from the employee's gross income and wages under the exclusion for DCAP benefits under § 129 of the Code. The remaining \$2,750 received by the employee is included in the employee's gross income and wages.



EXAMPLE 8

An employee is covered by a DCAP with a July 1 through June 30 plan year. For the 2020-21 plan year, the employee elects \$5,000 for DCAP benefits but incurs no dependent care expenses during the plan year. The employee carries over the unused \$5,000 of DCAP benefits to the 2021-22 plan year and elects \$10,500 for DCAP benefits for that plan year. The employee incurs no dependent care expenses during the period from 7/1/21 to 12/31/21 and has \$15,500 of DCAP benefits available as of 1/1/22.

For the tax year 2022, the exclusion for DCAP benefits under § 129 of the Code is \$5,000. The employee incurs \$15,500 in dependent care expenses during the period from 1/1/22 through 6/30/22 and is reimbursed \$15,500 by the DCAP. The employee makes no DCAP election for the 2022-23 plan year. Of the \$15,500 received in tax year 2022, \$10,000 is excluded from the employee's gross income and wages because \$5,000 is excluded under the exclusion for DCAP benefits under § 129 of the Code for the tax year 2022, and \$5,000 is excluded because it is attributable to a carryover permitted under the CAA of 2021 (which Notice 2021-26 clarifies would be excludable). The remaining \$5,500 is included in the employee's gross income and wages.



This document is provided for general information purposes only and should not be considered legal or tax advice or legal or tax opinion on any specific facts or circumstances. Readers are urged to consult their legal counsel and tax advisor concerning any legal or tax questions that may arise.

Contact

Visit us online or send us a message to learn more about the Hays Difference and our service offerings.

www.hayscompanies.com | info@hayscompanies.com

