

# COMPLIANCE OVERVIEW

Provided by Sullivan Benefits

## Dependent Care Assistance Programs

Internal Revenue Code (Code) Section 129 allows employers to provide dependent care assistance benefits for their employees on a tax-free basis. These benefit plans are referred to as dependent care assistance programs (DCAPs) or dependent care flexible spending accounts (FSAs).

Most DCAPs are structured so that employees make contributions on a pre-tax basis through a Code Section 125 cafeteria plan. As a general rule, married employees who file a joint tax return and unmarried employees may contribute up to \$5,000 each year to their DCAP accounts. The annual limit for married employees who file separate tax returns is \$2,500.

Benefits that an employee receives from his or her DCAP account are non-taxable if:

- The expenses are for the care of one or more qualifying individuals (for example, a child under the age of 13); and
- The employee incurs the expense in order to enable the employee (and the employee's spouse) to be gainfully employed.

### LINKS AND RESOURCES

- [Internal Revenue Code Section 129](#)
- [IRS Publication 503](#) – Child and Dependent Care Expenses
- [Instructions](#) for IRS Form W-2 (Employee Wage and Tax Statement)
- [Instructions](#) for IRS Form 2441 (Child and Dependent Care Expenses)

### HIGHLIGHTS

#### EMPLOYER REQUIREMENTS

- Adopt a plan document and communicate program to employees
- Establish a substantiation process for claims
- Comply with nondiscrimination rules
- Report DCAP benefits on Form W-2

#### COMMON ELIGIBLE EXPENSES

- Nursery school, preschool or a similar program below the kindergarten level
- Before- or after-school care
- Child care centers
- Day camp
- Babysitters (in some cases)

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## OVERVIEW

A DCAP, or a dependent care FSA, is an employer-sponsored benefit plan that allows employees to pay for certain dependent care expenses on a tax-free basis, up to a specified limit. In most cases, DCAPs are funded by employees with pre-tax dollars through payroll deductions. When employees incur eligible dependent care expenses, such as expenses for babysitting or child care, they can seek reimbursement from their DCAP account.

### **Plan Document and Employee Notification**

Employers that sponsor DCAPs are required to have a **written plan document** in place that describes the dependent care assistance benefits and complies with the requirements of Code Section 129.

Employers are also required to **notify employees of the DCAP's availability and terms**. As a best practice, this notification should remind employees that, in order to claim a tax exclusion for their DCAP benefits, they must file [IRS Form 2441](#) with their tax return.

**DCAP Plan Design:** Employers have the flexibility to design their DCAPs to be more restrictive than Code Section 129. For example, an employer may more narrowly define the qualifying individuals whose care can be reimbursed or the type of care that is eligible for reimbursement, provided the DCAP satisfies the applicable nondiscrimination requirements.

### **Applicable Laws**

DCAPs must comply with the restrictions of Code Section 129 in order to provide tax-free dependent care assistance benefits. Also, DCAPs that allow employees to make pre-tax contributions are subject to the Code Section 125 rules for cafeteria plans, including some (but not all) of the rules that apply to health FSAs.

A DCAP that reimburses employees for their dependent care expenses is generally not subject to the Employee Retirement Income Security Act (ERISA). Thus, ERISA's rules, including the Form 5500 reporting requirement, do not apply to DCAPs. Also, DCAPs are not group health plans, which means they are not subject to the Consolidated Omnibus Budget Reconciliation Act (COBRA), the Affordable Care Act (ACA) or the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Because DCAPs are not group health plans, participating in a DCAP does not jeopardize an individual's eligibility to make health savings account (HSA) contributions.

## ELIGIBILITY RULES

As a general rule, an employer may allow any **common law employee** to participate in its DCAP. Code Section 129 also allows self-employed individuals (for example, sole proprietors, partners in a

*Because DCAPs are not group health plans, they are not subject to COBRA, HIPAA or the ACA. Also, participating in a DCAP does not impact HSA eligibility.*

partnership or more-than-2-percent shareholders in a Subchapter S corporation) to participate in a DCAP, although self-employed individuals cannot make salary reduction contributions through a Section 125 cafeteria plan.

While employers often allow all of their employees to participate in their DCAPs, it is generally permissible for employers to limit participation to certain groups of employees (for example, employees working at a specific business location). However, before implementing any eligibility exclusions, employers should consider the Code's nondiscrimination requirements for DCAPs.

## CONTRIBUTIONS

Most DCAPs are designed so that employees make contributions on a pre-tax basis through a Section 125 cafeteria plan. These contributions are commonly referred to as "salary reduction contributions." Employers may also decide to make their own contributions to employees' DCAP accounts, subject to certain nondiscrimination requirements.

Employees who elect to participate in an employer's DCAP should carefully select the amount of their salary reduction contributions for the year, subject to the federal tax limits and any employer-imposed contribution limits.

When electing to participate in a DCAP, an employee must specify how much he or she would like to contribute for the year. The employee should choose an amount that is large enough to cover eligible expenses, but is not so large that the employee will forfeit unused funds at the end of the year.

Because DCAPs are subject to the Section 125 rules, employees **generally cannot change their elections during a coverage period (unless an exception applies)**. Also, DCAPs are subject to the "use or lose" rule under federal tax law, which means that unused amounts generally must be forfeited at the end of the coverage period.

Before electing to participate in a DCAP, an employee should confirm that the DCAP will provide him or her with greater tax benefits than the **dependent care tax credit** under [Code Section 21](#). A taxpayer cannot receive a tax credit for expenses that have been reimbursed from a DCAP. In general, most taxpayers (especially those with higher incomes) maximize their tax savings by using a DCAP. However, because this determination is based on each individual's circumstances, employees may wish to consult with their personal tax adviser before making DCAP elections.

## **Annual Limits**

The maximum amount that an employee may exclude from his or her income under a DCAP each year is limited to the **smallest of the following amounts**:

- ✓ **\$5,000** for a married employee who files a joint tax return or an unmarried employee (**\$2,500** for a married employee who files separately);
- ✓ The employee's earned income for the year; or
- ✓ The spouse's earned income, if the employee is married at the end of the year.

These dollar limits are not indexed for inflation, so they do not change from year to year. Also, DCAPs are not subject to the \$2,500 annual limit (as adjusted for inflation) that applies to health FSA salary reduction contributions.

For purposes of the annual DCAP limits, "earned income" includes wages, salaries, tips, other taxable employee compensation and net earnings from self-employment. Generally, only taxable compensation is considered earned income, although individuals may elect to include nontaxable combat pay in their earned income.

Also, there is a special rule for determining the earned income of an employee's spouse who is a full-time student or who is incapable of self-care and has the same principal place of abode as the employee for more than half of the year. A spouse who qualifies for this special rule is deemed to be gainfully employed and deemed to have an earned income of not less than \$250 per month for one qualifying dependent or \$500 per month for two or more qualifying dependents.

**The \$5,000 limit for married spouses is a joint limit, which means that spouses filing jointly may NOT each claim \$5,000 in DCAP benefits.** Employers that sponsor DCAPs should help employees understand these limits by including an explanation of the \$5,000/\$2,500 and earned income limits in the DCAP's enrollment materials. Employers may want to include a statement explaining that if an employee's spouse also has DCAP benefits available through his or her employer, their elections for a year, when added together, cannot exceed \$5,000 if they file a joint tax return.

### ***Who is a "spouse?"***

Under federal law, a "spouse" is defined as a legally married opposite-sex or same-sex spouse. Partners in a registered domestic partnership or civil union are not considered "spouses" under federal tax law (even though they may be treated as "spouses" under state law).

## **Election Change Rules**

The Code Section 125 restrictions on mid-year election changes apply to DCAPs that include salary reduction contributions. Under Section 125, participant elections must be made before the first day of the plan year and must remain in effect until the beginning of the next plan year. This means that

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participants typically cannot make changes to their Section 125 cafeteria plan elections during a plan year.

Employers do not have to permit any exceptions to the election irrevocability rule for Section 125 cafeteria plans. However, [IRS regulations](#) permit employers to design their cafeteria plans to allow employees to change their elections during the plan year, if certain conditions are met. Although many of the IRS' mid-year election change events only apply to group health plans, DCAPs may be designed to allow employees to change their elections when the following events occur, provided that the employee's requested change is consistent with the event:

Event	Description
<b>Change in Status Event</b>	A change in the employee's number of dependents, a change in employment status of the employee, a change in the place of residence of the employee, spouse or dependent or the employee's spouse or a dependent child ceasing to satisfy dependent eligibility requirements. For example, an employee (or employee's spouse) changes work schedules from full-time to part-time, which reduces the hours of child care needed and the amount of dependent care expenses.
<b>Changes in Cost or Coverage</b>	Certain changes in cost and coverage under the DCAP may allow a participant to change his or her election during the plan year. This may occur, for example, when a child care provider changes its rates or when an employee switches day care providers.
<b>Family Medical Leave Act (FMLA) Leave</b>	Employees who take an FMLA leave are entitled to revoke an election of non-health benefits (such as DCAP benefits) under a Section 125 cafeteria plan to the same extent as employees taking a non-FMLA leave are permitted to revoke elections of non-health benefits under a Section 125 cafeteria plan.

## REIMBURSEMENTS

### *Eligible Expenses*

Under Code Section 129, a dependent care expense is eligible for reimbursement from a DCAP only if it is an otherwise unreimbursed work-related expense. To qualify as a work-related expense, the expense must satisfy the following two requirements:

- ✓ The expense must be primarily for the **care of a qualifying individual**; and

- ✓ The expense must be incurred in order to enable the employee (and the employee's spouse) to be **gainfully employed**.

Federal tax law indicates that employers should have a **reasonable belief** that the expenses that are reimbursed under their DCAPs are actually eligible expenses. To comply with this requirement, employers should clearly communicate the rules for eligible expenses to employees who participate in the DCAP. Employers may also want to remind employees of these rules each time they submit a claim for reimbursement.

### *Care of Qualifying Individuals*

To qualify as a work-related expense that may be reimbursed under a DCAP, the expense must be to provide care for a qualifying individual. The following sections address these Code Section 129 requirements in more detail.

### Qualifying Individuals

For purposes of dependent care benefits under Code Section 129, a qualifying individual includes:

- ✓ The taxpayer's dependent child who has not attained age 13;
- ✓ The taxpayer's spouse who is mentally or physically incapable of self-care and who has the same principal place of abode as the taxpayer for more than half of the year; or
- ✓ A dependent of the taxpayer who is mentally or physically incapable of self-care and who has the same principal place of abode as the taxpayer for more than half of the year.

#### ***Who is a "child?"***

An employee's child includes a son, daughter, stepson or stepdaughter, and an eligible foster child of the employee. Based on the federal tax rules, the child of an employee's domestic partner will not, in most cases, satisfy the requirements for a qualifying individual.

Whether someone is a qualifying individual must be calculated on a daily basis. For example, an employee may no longer seek reimbursement for dependent care expenses incurred after his or her qualifying child's 13th birthday. Employees should take into consideration the daily calculation requirement when making their annual elections.

Persons who cannot dress, clean or feed themselves because of physical or mental problems are considered unable to care for themselves. Also, persons who must have constant attention to prevent them from injuring themselves or others are considered unable to care for themselves.

### Care

In general, expenses are for the care of a qualifying individual only if their main purpose is the person's well-being and protection. An employee does not have to choose the least expensive care alternative that is available. The cost of a paid care provider may be an eligible care expense even if another care provider is available at no cost.

Not all expenses related to a qualifying individual are for the individual’s care. Expenses for care do not include amounts that taxpayers pay for food, lodging, clothing, education and entertainment. However, small amounts paid for these expenses may be reimbursable if they are incidental to and cannot be separated from the cost of caring for the qualifying individual.

Child support payments are not for care and cannot be reimbursed through a DCAP. Expenses for household services may qualify as reimbursable expenses if the services are performed in connection with the care of a qualifying individual. Services performed by chauffeurs, bartenders or gardeners are not household services.

The following table addresses whether certain types of common expenses are eligible care expenses:

Type of Expense	Eligible Expense?
<b>Babysitters (inside or outside of the taxpayer’s home)</b>	<p>Expenses for babysitters are eligible care expenses, unless the babysitter is:</p> <ul style="list-style-type: none"> <li>• The employee’s child, stepchild or eligible foster child who is under the age of 19;</li> <li>• A tax dependent of the employee or the employee’s spouse;</li> <li>• The employee’s spouse; or</li> <li>• The parent of the employee’s qualifying child who is under the age of 13.</li> </ul>
<b>Camp</b>	<p>The cost of day camp may be for the care of a qualifying individual and a work-related eligible expense, even if the camp specializes in a particular activity, such as computers or soccer. The cost of sending a child to an overnight camp is not considered a work-related expense.</p>
<b>Dependent Care Centers (or child care centers or day care centers)</b>	<p>Expenses for care provided outside of a taxpayer’s home at a dependent care center is an eligible expense for care, assuming the center complies with all state and local regulations.</p> <p>A dependent care center is a facility (including a nonprofit facility) that provides care for more than six individuals (not counting individuals who reside at the center) and receives a fee, payment or grant for providing these services.</p>
<b>Custodial Care</b>	<p>The cost of custodial care (or care services outside of the employee’s household) is only reimbursable if the care is for a qualifying individual and, if the qualifying individual is not a qualifying child under the age of 13, the individual must regularly spend at least eight hours each day in the</p>

	<p>employee's household. Due to this restriction, a DCAP cannot reimburse nursing home expenses.</p>
<b>Fees and Deposits</b>	<p>Fees and deposits that an employee has to pay for care are eligible expenses even though they are not directly for care. Examples of fees and deposits include the following:</p> <ul style="list-style-type: none"><li>• Fees paid to an agency to get obtain the services of a care provider,</li><li>• Deposits paid to an agency or preschool</li><li>• Application fees</li><li>• Other indirect expenses</li></ul> <p>However, a forfeited deposit is not an eligible expense if care is not provided.</p>
<b>Home Care</b>	<p>The cost of home care (by a nanny or au pair, for example) is an eligible expense if it is attributable to the care of a qualifying individual. Also, the additional cost of providing room and board for a caregiver over usual household expenditures may be a work-related expense.</p>
<b>School</b>	<p>Expenses for a child in nursery school, preschool or a similar program for children below the level of kindergarten are expenses for care. Expenses to attend kindergarten or a higher grade are not eligible expenses. Expenses for summer school or tutoring programs are also ineligible. However, expenses for before- or after-school care of a child may be eligible expenses for care.</p>
<b>Transportation</b>	<p>If a care provider takes a qualifying individual to or from a place where care is provided, the transportation is for the care of the qualifying individual. This includes transportation by bus, subway, taxi or private car. Transportation costs for a care provider to come to an employee's home are not considered to be employment-related expenses.</p>

### *Gainfully Employed*

To qualify as a dependent care expense that may be reimbursed under a DCAP, the expense must be incurred in order to enable the employee (and the employee's spouse) to be gainfully employed. In other words, the expense must be incurred to allow the employee (and the employee's spouse) to work or look for work.

If an employee is married, generally both the employee and the spouse must work or look for work. However, a spouse may be treated as working for any month when he or she is a full-time student or mentally or physically incapable of self-care with the same principal abode as the employee for more than half of the year.



An employee's (or spouse's) gainful employment may consist of work within or outside of the home, including self-employment. This work can be on a full-time or part-time basis. Gainful employment also includes time spent actively looking for work, although periods of unemployment may reduce a taxpayer's DCAP benefits due to the earned income limits.

## KEY POINT

An expense is not considered work-related merely because it is incurred while an employee (or spouse) is working. Rather, the purpose of the expense must be to allow the taxpayer to work. Whether an expense allows a taxpayer to work or look for work depends on the facts of each situation and is determined on a daily basis.

IRS regulations provide the following guidance on gainful employment:

- ✓ An individual who works as a **volunteer or for nominal consideration** is not considered to be gainfully employed.
- ✓ A taxpayer is not required to allocate expenses during **short, temporary absences from work**, such as for minor illness or vacation, if the taxpayer is required to pay for care during the absence. An absence of two weeks or less is considered a short, temporary absence. An absence of more than two weeks may also be considered a short, temporary absence, depending on the circumstances.
- ✓ **Part-time employees** may only seek reimbursement for dependent care expenses incurred on working days. If the employee works at least one hour, dependent care expenses for that day are eligible. Also, if a part-time employee is required to pay for care on a weekly or monthly basis and that period includes working and non-working days, the employee is not required to allocate expenses.

**Example:** An employee works three days each week. While the employee works, her 6-year-old child attends a day care center. The employee can pay the center \$150 for three days of care per week or \$250 for five days of care per week. The employee's child attends the center five days a week. The employee's work-related expenses are limited to \$150 per week. However, if the center does not offer the three-day option and requires the employee to pay \$250, the entire \$250 weekly fee may be a work-related expense.

## Other Rules for Reimbursements

### "Use or Lose" Rule

DCAPs are subject to the Code's "use or lose" rule for FSAs. Under this rule, **any unused funds in the DCAP at the end of the coverage period generally cannot be carried over to the next coverage period and must be forfeited.** A DCAP's coverage period, or plan year, must be 12 months long, although short plan years are permitted in some situations.

The IRS allows employers to design their DCAP with an extended deadline, or grace period, of **two and a half months** after the end of a plan year to use DCAP funds. Thus, for a plan year ending Dec. 31, the employees would have until March 15 to spend the funds in their DCAP. Allowing a grace period is optional for employers that sponsor DCAPs.

Also, a grace period is different than a “run-out” period for submitting claims. Most DCAPs are designed with a run-out period that gives participants time after the end of the coverage period for submitting claims for eligible expenses that were incurred during the coverage period. Unlike a grace period, a run-out period does not allow a DCAP to reimburse claims incurred after the coverage period ended.

### *Timing Rules*

A DCAP can only reimburse eligible dependent care expenses that were incurred during the plan’s coverage period (including any grace period, if applicable). Dependent care expenses that were incurred before or after the coverage period are not eligible for reimbursement for that coverage period.

Dependent care expenses are incurred when the services are provided, and not when an employee is billed for the expense or pays for the care. Thus, as a general rule, DCAPs cannot provide advance reimbursements of future dependent care expenses.

IRS regulations permit DCAPs to incorporate a spend-down provision for employees whose participation terminates during a coverage period. At the employer's option, a DCAP may allow terminated participants to use unused amounts in their accounts for dependent care expenses incurred during the remainder of the coverage period (or grace period immediately after that plan year, if applicable). If an employer does not incorporate a spend-down provision in its DCAP, terminated employees forfeit any unused balances remaining in their DCAP accounts at the time of the termination, subject to any run-out period for submitting claims.

**The uniform coverage rule that applies to health FSAs does not apply to DCAPs.** The uniform coverage rule requires that the maximum amount of reimbursement from a health FSA must be available at all times during the coverage, only reduced for prior distributions during the coverage period. Because DCAPs are not subject to the uniform coverage rule, a DCAP may limit reimbursement of eligible expenses to the amount that has been contributed to the employee’s DCAP account at the time when he or she requests reimbursement, reduced by any amounts already reimbursed.

*Dependent care expenses cannot be reimbursed until they are actually incurred. When a child care center requires pre-payment, employees may be required to pay these expenses out-of-pocket and then seek reimbursement from their DCAP accounts after the services are provided.*

## *Substantiation*

All employee requests for DCAP reimbursements must be substantiated with information from a third party (that is, someone other than the employee and his or her spouse or dependents) to ensure that only eligible expenses are reimbursed. The independent third party must provide information describing the expense, the date of the service or sale and the amount.

## OTHER LEGAL REQUIREMENTS

### ***Nondiscrimination***

Federal tax law imposes nondiscrimination requirements on DCAPs to make sure that they do not discriminate in favor of highly compensated employees (HCEs). If a DCAP is discriminatory, the benefits provided to HCEs will be taxable, but the non-HCEs' benefits will not be affected. Discriminatory benefits under a DCAP are reported as wages in Box 1 of the HCE's Form W-2.

In order to avoid adverse consequences to the HCEs, a DCAP must satisfy the following nondiscrimination tests under Code Section 129:

#### ***Who is an "HCE"?***

For purposes of the DCAP nondiscrimination requirements, an HCE is any employee whose compensation during the preceding plan year exceeded \$120,000 or who was a more-than-5 percent owners in the current or preceding plan year.

- ✓ ***Eligibility***—A DCAP must not discriminate in favor of HCEs as to eligibility to participate. This nondiscrimination test looks at whether there is a bona fide business reason for any exclusions and whether a sufficient percentage of non-HCEs are eligible to participate in the DCAP.
- ✓ ***Contributions and Benefits***—A DCAP must not discriminate in favor of HCEs as to contributions and benefits received under the plan. This test considers whether HCEs and non-HCEs receive the same amount of employer contributions (if any) and whether they are entitled to same amount of benefits from the DCAP.
- ✓ ***Owner Concentration Test***—Not more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are shareholders or owners, each of whom (on any day of the year) own more than 5 percent of the stock or of the capital or profits interest in the employer. This nondiscrimination test looks at DCAP utilization to make sure that certain HCEs do not receive more than 25 percent of the DCAP's benefits.
- ✓ ***55 Percent Average Benefits Test***—The average benefits provided to employees who are non-HCEs must be at least 55 percent of the average benefits provided to HCEs. This test is intended to ensure that HCEs do not disproportionately utilize the DCAP's benefits.

DCAPs that are offered under cafeteria plans are also subject the additional nondiscrimination testing requirements that apply to these plans under Code Section 125.

## ***Tax Reporting***

Employers must report the total amount of dependent care benefits in Box 10 (Dependent care benefits) of [IRS Form W-2](#). Employers must include the dependent care benefits provided to the employee under DCAP, including any amounts exceeding \$5,000.

Employees who participate in their employer's DCAP should complete [IRS Form 2441 \(Child and Dependent Care Expenses\)](#) and attach it to their federal income tax return to demonstrate to the IRS that their dependent care assistance benefits are non-taxable. If any portion of the dependent care assistance benefits is taxable, Form 2441 directs the employee to include those amounts as taxable income on his or her tax return. Form 2441 also requires the employee to provide the care provider's name, address and taxpayer identification number (or Social Security number for individuals) in order to exclude the dependent care benefits from income.