

TAXATION OF DEPENDENT CARE BENEFITS AVAILABLE PURSUANT TO AN EXTENDED CLAIMS PERIOD OR CARRYOVER

NOTICE 2021-26

PURPOSE

This notice addresses the taxation of dependent care benefits, provided through a dependent care assistance program, available in taxable years ending in 2021 and 2022 due to the application of either the carryover or the extension of a claims period under § 214 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the Act), enacted as Division EE of the Consolidated Appropriations Act, 2021, Pub. L. 116-260, 134 Stat. 1182 (Dec. 27, 2020) (CAA). The notice clarifies that if these dependent care benefits would have been excluded from income if used during the preceding taxable year (that is, during the taxable year ending in 2020 or 2021, as applicable), they will remain excludable from gross income and are not wages of the employee for the taxable years ending in 2021 and 2022. In addition, the notice clarifies that these benefits will not be taken into account for purposes of the application of the limits under § 129 of the Internal Revenue Code (Code) to other dependent care benefits available for the taxable years ending in 2021 and 2022.

BACKGROUND

A. Dependent Care Assistance Programs – In General

Section 129 of the Code provides an exclusion from gross income of an employee for amounts paid or incurred by the employer for dependent care assistance benefits provided to the employee if the assistance is furnished pursuant to a dependent care assistance program (DCAP) described in § 129. Section 129(a)(2) limits the benefits that may be excluded with respect to dependent care assistance services provided during the taxable year. For 2020, the exclusion could not exceed \$5,000, or \$2,500 in the case of a separate return filed by a married individual.

DCAPs may be provided by a flexible spending arrangement (FSA) under a § 125 cafeteria plan. Thus, an employee may contribute to the DCAP through salary reduction, and the DCAP may reimburse the employee for dependent care expenses incurred during the year. The reimbursements of dependent care expenses are excluded from gross income under § 129. Reimbursements that are not excludable under § 129 are includable in the employee's gross income and wages.¹

The limitation under § 129 applies to amounts paid or reimbursed for dependent care services provided during the taxable year of the employee. Under Notice 2005-42,

¹ Under §§ 3121(a)(18) and 3401(a)(18), any payment made or benefit furnished to an employee is excluded from wages if at the time of the payment or furnishing it is reasonable to believe that the employee will be able to exclude the payment or benefit from income under § 129.

2005-1 CB 1204, unused benefits in a DCAP may be used during a 2½ month grace period following the end of the plan year. If the sum of DCAP benefits used in the taxable year (including unused DCAP benefits used during a grace period, or a portion thereof, that falls in the taxable year) exceeds the applicable limit under § 129, however, the excess is taxable.

B. Section 214(a) and (b) of the Act – Carryovers and Extended Claims Periods

Section 214(a) and (b) of the Act allow DCAPs to carry over unused benefits 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. Alternatively, § 214(c)(1) allows a DCAP to extend its claims period for a plan year ending in 2020 or 2021 to 12 months after the end of the plan year with respect to unused benefits remaining in the DCAP.

Notice 2021-15, 2021-10 IRB 898, provides guidance regarding the implementation of the temporary ability under § 214 of the Act to allow unused DCAP benefits remaining at the end of a plan year to reimburse dependent care expenses incurred in the next plan year, either due to a carryover or an extended period for incurring claims. Notice 2021-15 states that:

If an employer adopts the § 214 carryover or the extended period for incurring claims permitted by § 214(c)(1) of the Act, the annual limits under §§ 125(i) and 129(a) apply to amounts contributed to a health FSA or dependent care assistance program for a particular year, and not to amounts reimbursed or otherwise available for reimbursement from a health FSA or dependent care assistance program in a particular plan or calendar year. Thus, unused 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.

C. Section 9632 of the American Rescue Plan Act of 2021 – Increase of Benefit Limit under § 129 of the Code to \$10,500 for Taxable Year Beginning after December 31, 2020, and before January 1, 2022

Section 9632 of the American Rescue Plan Act of 2021 (ARP), Pub. L. 117-2, 135 Stat. 4 (March 11, 2021), increases the exclusion for employer-provided dependent care under § 129 to \$10,500 (half that amount in the case of a married individual filing separately) with respect to any taxable year beginning after December 31, 2020, and before January 1, 2022. Section 9632(c) of the ARP provides that a DCAP generally may be amended retroactively to increase the contribution allowed under the plan if (1) the amendment is adopted no later than the last day of the plan year in which the amendment is effective, and (2) the plan is operated consistent with the terms of the amendment during the period beginning on the effective date of the amendment and ending on the date the amendment is adopted.

Section 9632 of the ARP increases the exclusion for employer-provided dependent care under § 129 to \$10,500 (half that amount in the case of a married individual filing separately) for the individual's 2021 taxable year (not the plan year). Accordingly, in the case of a DCAP offered by a § 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. Also, unused DCAP benefits from one taxable year of the participant (typically the calendar year) used to reimburse expenses incurred in the immediately following taxable year, where the expenses are incurred during the same non-calendar plan year spanning those two taxable years, are not carryover benefits or benefits made available under an extended claims period. Accordingly, the guidance provided in this notice does not apply to these benefits.

GUIDANCE – TREATMENT OF UNUSED BENEFITS MADE AVAILABLE IN 2021 OR 2022 DUE TO A CARRYOVER OR EXTENDED CLAIMS PERIOD

Notice 2021-15 states that in applying the temporary ability to carry over amounts or extend claims periods under § 214 of the Act, unused 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. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have concluded that inherent in the legislation temporarily permitting unused amounts to be carried over to 2021 or 2022, or made available under an extended claims period, is that amounts that continue to be available are excluded from income if used by the participant for dependent care benefits. Consequently, this notice clarifies 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. This notice also provides examples illustrating the possible tax consequences of electing \$10,500 in DCAP benefits for a plan year beginning in 2021 but ending in 2022.

In the following examples, the employee's taxable year is the calendar year and the employee is not a married individual filing separately. The DCAP and the § 125 cafeteria plan comply with all applicable statutory requirements in effect as of the date this notice is published (including applicable nondiscrimination requirements) for all relevant periods. Consistent with current law, the examples assume that the § 129 exclusion for the 2022 taxable year reverts to \$5,000.

EXAMPLE 1: An employee is covered by a calendar year § 125 cafeteria plan that offers a DCAP benefit. The employee elects no DCAP benefits for the 2019 plan year.

The employee elects to contribute \$5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the plan year. Pursuant to § 214 of the Act, the § 125 cafeteria plan allows the employee to carry over the unused \$5,000 of DCAP benefits to the 2021 plan year. The employee elects to contribute \$10,500 for DCAP benefits 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 attributable to a carryover permitted under § 214 of the Act.

EXAMPLE 2: An employee is covered by a non-calendar year § 125 cafeteria plan that offers a DCAP benefit. The § 125 cafeteria plan has a July 1 to June 30 plan year. The employee elects no DCAP benefits for the plan year beginning July 1, 2019. For the plan year beginning July 1, 2020, the employee elects to contribute \$5,000 for DCAP benefits, but the employee incurs no dependent care expenses during the plan year. Pursuant to § 214 of the Act, the § 125 cafeteria plan allows the employee to carry over the unused \$5,000 of DCAP benefits to the plan year beginning July 1, 2021.

Taxable Year 2021 – Facts and Conclusion. Pursuant to § 9632 of the ARP, the employee elects to contribute \$10,500 for DCAP benefits for the plan year beginning July 1, 2021. The employee has \$15,500 available for dependent care expenses for the plan year beginning July 1, 2021. The employee incurs no dependent care expenses during the period from July 1, 2021, to December 31, 2021, and has \$15,500 of DCAP benefits available as of January 1, 2022. For the taxable year 2021, the employee did not receive any DCAP benefits because no dependent care expenses eligible for reimbursement under the DCAP were incurred in 2021.

Taxable Year 2022 – Facts and Conclusion. For the taxable year 2022, the exclusion for DCAP benefits under § 129 of the Code is \$5,000. The employee incurs \$7,000 in dependent care expenses during the period from January 1, 2022, through June 30, 2022, and is reimbursed \$7,000 by the DCAP. The § 125 cafeteria plan adopts a 2½ month grace period that is added to the end of the plan year beginning July 1, 2021, which allows the employee to use the unused \$8,500 of DCAP benefits until September 15, 2022. The employee elects to contribute \$5,000 for DCAP benefits for the plan year beginning July 1, 2022. The employee incurs \$8,500 in dependent care expenses during the period from July 1, 2022, through September 15, 2022, and incurs \$2,500 in dependent care expenses during the period from September 15, 2022, through December 31, 2022. The employee is reimbursed \$11,000 by the DCAP (\$8,500 plus \$2,500). The employee therefore receives \$18,000 (\$7,000 plus \$11,000) in reimbursements of dependent care expenses during the 2022 taxable year. Of the \$18,000 received in calendar 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 taxable year 2022, and \$5,000 of the \$7,000 received from January 1, 2022, to June 30, 2022, is excluded because it is attributable to carryovers permitted under § 214 of the Act that would have been

excluded from gross income if used in the preceding taxable year (that is, attributable to carryovers to plan years ending before 2023). The remaining \$8,000 is included in the employee's gross income and wages because it is not attributable to carryovers permitted under § 214 of the Act.

EXAMPLE 3: An employee is covered by a non-calendar year § 125 cafeteria plan that offers a DCAP benefit. The § 125 cafeteria plan has a July 1 to June 30 plan year. The employee elects no DCAP benefits for the plan year beginning July 1, 2020, and there are no unused amounts from prior plan years available.

Taxable Year 2021 – Facts and Conclusion. Pursuant to § 9632 of the ARP, the employee elects to contribute \$10,500 for DCAP benefits for the plan year beginning July 1, 2021. The employee incurs \$5,000 in dependent care expenses during the period from July 1, 2021, to December 31, 2021, and receives \$5,000 in reimbursements during 2021. The \$5,000 is excluded from the employee's gross income and wages pursuant to § 129 of the Code. The employee has \$5,500 of DCAP benefits available as of January 1, 2022.

Taxable Year 2022 – Facts and Conclusion. For the taxable year 2022, the exclusion for DCAP benefits under § 129 of the Code is \$5,000. The employee incurs \$5,500 in dependent care expenses during the period from January 1, 2022, through June 30, 2022, and is reimbursed \$5,500 by the DCAP. The employee elects to contribute \$5,000 for DCAP benefits for the plan year beginning July 1, 2022. The employee incurs \$2,500 in dependent care expenses during the period from July 1, 2022, to December 31, 2022, and is reimbursed \$2,500 by the DCAP. The employee receives a total of \$8,000 in reimbursements for DCAP benefits during 2022. Of the \$8,000 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 \$3,000 received by the employee is included in the employee's gross income and wages.

EFFECT ON OTHER DOCUMENTS

This notice clarifies the application of Notice 2021-15.

DRAFTING INFORMATION

The principal author of this notice is Jennifer Solomon of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), though other Treasury Department and IRS officials participated in its development. For further information on the provisions of this notice, contact Jennifer Solomon at (202) 317-5500 (not a toll-free number).