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EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

IRS ISSUES GUIDANCE CLARIFYING TAX IMPLICATIONS OF CARRYOVER AND EXTENDED GRACE PERIOD FEATURES UNDER DEPENDENT CARE ASSISTANCE PROGRAMS

On May 10, 2021, the Internal Revenue Service ("IRS") issued Notice 2021-26 (the "Notice") addressing the taxation of dependent care benefits provided through a dependent care assistance program. The Notice explains that if dependent care benefits attributable to a carryover or an extended grace period would have been excluded from income if used in the prior taxable year (i.e., 2020 or 2021), then those dependent care benefits will be excludable from gross income and will not be considered wages of the employee if used to reimburse eligible dependent care expenses in 2021 or 2022. This guidance clarifies tax treatment questions that arose in connection with a dependent care provision in the Taxpayer Certainty and Disaster Tax Relief Act of 2020, which is part of the Consolidated Appropriations Act, 2021 ("2021 Appropriations Act") and a subsequent change made by the American Rescue Plan Act ("ARPA").

Background

Generally, when an employee is reimbursed for eligible dependent care expenses through a dependent care assistance program, those reimbursements are excluded from the employee's gross income under Section 129 of the Internal Revenue Code (the "Code"). The amount that may be excluded from an employee's gross income per taxable year is subject to a limit, and for 2020, the amount excluded could not exceed the lesser of (i) $5,000 (or $2,500 for taxpayers who are married filing separately), (ii) the amount of the employee's earned income for the year, or (iii) the earned income of the employee's spouse.

This year, the general income exclusion rules described above were complicated by the enactment of Section 214 of the 2021 Appropriations Act ("Section 214"). Section 214 permits employers to amend their dependent care assistance program to add a carryover feature whereby employees may carry over an unlimited amount of unused dependent care assistance program contributions that remain in the dependent care assistance program at the end of the 2020 plan year into 2021 and an unlimited amount of unused dependent care assistance program contributions that remain in the dependent care assistance program at the end of the 2021 plan year into 2022. Alternatively, Section 214 allows employers to amend their dependent care assistance program to add an extended grace period feature whereby employees may continue to be reimbursed from unused dependent care assistance program contributions for eligible dependent care expenses incurred for up to a period of 12 months after the end of the plan year, for plan years ending in 2020 and 2021. Practically, either option accomplishes the same goal. Prior IRS guidance addressing Section 214 (Notice 2021-15) did not provide relief from the normal dependent care assistance program tax treatment rules for amounts carried over to subsequent years. Under normal rules, such

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amounts would be taxable to the employee if the total amount carried over from the prior year, plus the employee's dependent care assistance program election for the year, exceeded the excludable amount.

So, for example, if an employer amended its program to allow employees to carry over an unlimited amount of unused 2020 contributions, and an employee carried over $2,000 in unused 2020 contributions to 2021, and also elected to contribute $5,000 in 2021 and was reimbursed the full $7,000 in dependent care expenses in 2021, under normal rules, the employee would be taxable on $2,000 (the amount by which reimbursements exceeded the normal $5,000 exclusion limit).

The ARPA, enacted March 11, 2021, implements a one-year increase in the maximum excludable amount for dependent care assistance benefits from $5,000 to $10,500 (from $2,500 to $5,250 for taxpayers who are married filing separately) and allows employers to amend their dependent care assistance programs to increase the permissible amount of employee contributions to reflect the increased exclusion amount. The ARPA provision didn't expressly provide relief from the normal tax treatment of carried-over dependent care assistance program amounts described above, but one could conclude that the practical effect of the increased exclusion amount for the 2021 tax year would "solve" the taxability issue created by carryovers/extended grace periods for unused 2020 dependent care assistance contributions.

Notice 2021-26

In the Notice, the IRS expressly provides for that tax relief. The Notice clarifies that unused amounts carried over or made available under an extended grace period will be excluded from employees' gross incomes if the amounts are used to reimburse eligible dependent care expenses and would have been excluded from gross income if the amounts were used in the 2020 or 2021 taxable years. An employer does not need to amend its dependent care assistance program to increase the permissible 2021 contribution amount in order for this favorable tax treatment to apply to carried over/grace period amounts.

So, for the example described above, the employee would be able to exclude the full $7,000 in reimbursements from the employee's 2021 income because the $5,000 is excluded as 2021 benefits and the remaining $2,000 is attributable to a permissible carryover from 2020 and would have been excluded from income if the employee had used the amount in 2020.

Note that if an employer does amend its dependent care assistance program to increase the maximum contribution amount for 2021 to $10,500 and to permit a carryover of up to $5,000 from 2020 to 2021, an employee could carry over a full $5,000 from 2020 to 2021, elect to contribute $10,500 for 2021, and receive tax-free reimbursements for qualifying dependent care expenses up to $15,500 in 2021.

For dependent care assistance programs that do not operate on a calendar year basis (e.g., a program with a July 1 - June 30 plan year), the rules are somewhat more complicated to apply. The Notice contains several examples that employers with non-calendar year programs should review.

Conclusion

The Notice is welcome clarification for employers who have or are considering amending their dependent care assistance programs to permit carry overs or extended grace periods and provides tax relief for employees who are able to take advantage of such amendments. It is not too late for an employer to increase

its dependent care assistance program limit from $5,000 to $10,500 for the 2021 plan year (an amendment would be required by the end of the 2021 plan year). An employer could also allow employees to prospectively increase their 2021 plan year elections, which would have been based on a $5,000 limit. Keep in mind, though, that increasing the limit to $10,500 may increase the risk of failing the 55% average benefits test, as highly compensated employees may be more likely to increase their elections than non-highly compensated employees.[1]

If you would like more information regarding the tax implications of adopting the carryover or extended grace period features or have any questions regarding the various guidance relating to dependent care assistance programs and the carryover and extended grace period features, please contact any member of the Employee Benefits and Executive Compensation group at 585.232.6500 or 716.853.1616, or visit www.hselaw.com.

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[1] The 55% average benefits test is designed to ensure that benefits received by non-highly compensated employees is at least, on average, 55% of the average benefits received by highly compensated employees. If a dependent care assistance program fails the average benefits test, then highly compensated employees are taxable on dependent care assistance program benefits received during the year. To avoid this result, most employers do a preliminary test during the plan year to determine whether the dependent care assistance program would be projected to fail, and if so, reduce the elections of highly compensated employees to a level that will ensure passing. For employers that frequently have to reduce the elections of highly compensated employees to ensure passing the test, it may not be worth increasing the limit to $10,500.