

PART IV: DEPENDENT CARE ASSISTANCE PROGRAMS

In General

3597. What are the income tax consequences of an employer-sponsored dependent care assistance program?

A dependent care assistance program (“DCAP”) is a separate written plan of an employer for the exclusive benefit of providing employees with payment for or the provision of services that, if paid for by the employee, would be considered employment-related expenses under IRC Section 21(b)(2).¹ Employment-related expenses are amounts incurred to permit the taxpayer to be gainfully employed while he or she has one or more dependents under age thirteen (for whom he or she is entitled to a personal exemption deduction under IRC Section 151(c)) or a dependent or spouse who cannot care for themselves. The expenses may be for household services or for the care of the dependents.² The plan is not required to be funded.³

Non-highly compensated employees may exclude from income a limited amount for services paid or incurred by the employer under such a program provided during a taxable year.⁴ For highly compensated employees to enjoy the same income tax exclusion, the program must meet the following additional requirements.

- (1) Plan contributions or benefits must not discriminate in favor of highly compensated employees as defined in IRC Section 414(q) (Q 3827) or their dependents.
- (2) The program must benefit employees in a classification that does not discriminate in favor of highly compensated employees or their dependents.
- (3) No more than 25 percent of the amounts paid by the employer for dependent care assistance may be provided for the class of shareholders and owners each of whom owns more than 5 percent of the stock or of the capital or profits interest in the employer (certain attribution rules under IRC Section 1563 apply).
- (4) Reasonable notification of the availability and terms of the program must be provided to eligible employees.
- (5) The plan must provide each employee, on or before January 31, with a written statement of the expenses or amounts paid by the employer in providing such employee with dependent care assistance during the previous calendar year.

1. IRC Secs. 129(d)(1), 129(e)(1).

2. IRC Sec. 21(b)(2).

3. IRS Sec. 129(d)(5).

4. IRC Sec. 129(d)(1).

- (6) The average benefits provided to non-highly compensated employees under all plans of the employer must equal at least 55 percent of the average benefits provided to the highly compensated employees under all plans of the employer.¹

If benefits are provided through a salary reduction agreement, the plan may disregard any employee with compensation less than \$25,000 for purposes of the 55 percent test.² For this purpose, compensation is defined in IRC Section 414(q)(4), but regulations may permit an employer to elect to determine compensation on any other nondiscriminatory basis.³

For purposes of the eligibility and benefits requirements (items (2) and (6) above), the employer may exclude from consideration (1) employees who have not attained age 21 and completed one year of service (provided all such employees are excluded), and (2) employees covered by a collective bargaining agreement (provided there is evidence of good faith bargaining regarding dependent care assistance).⁴

A program will not fail to meet the requirements above, other than the 25 percent test applicable to more than 5 percent shareholders, or the 55 percent test applicable to benefits, merely because of the utilization rates for different types of assistance available under the program. The 55 percent test may be applied on a separate line of business basis.⁵

Amount Excludable

An employee may exclude up to \$5,000 paid or incurred by the employer for dependent care assistance provided during a tax year.⁶ For a married individual filing separately, the excludable amount is limited to \$2,500. Furthermore, the amount excluded cannot exceed the earned income of an unmarried employee or the lesser of the earned income of a married employee or the earned income of the employee's spouse.⁷

An employee cannot exclude from gross income any amount paid to an individual with respect to whom the employee or the employee's spouse is entitled to take a personal exemption deduction under IRC Section 151(c) or who is a child of the employee under nineteen years of age at the close of the taxable year.⁸

With respect to on-site facilities, the amount of dependent care assistance excluded is based on utilization by a dependent and the value of the services provided with respect to that dependent.⁹

1. IRC Sec. 129(d).
2. IRC Sec. 129(d)(8)(B).
3. IRC Sec. 129(d)(8)(B).
4. IRC Sec. 129(d)(9).
5. See IRC Sec. 414(r).
6. IRC Sec. 129(a).
7. IRC Sec. 129(b).
8. IRC Sec. 129(c).
9. IRC Sec. 129(e)(8).

Grace Period

An employer may, at the employer's option, amend its plan document to include a grace period, which must not extend beyond the fifteenth day of the third calendar month after the end of the immediately preceding plan year to which it relates (i.e., the "2½ month rule"). If a plan document is amended to include a grace period, a participant who has unused benefits or contributions relating to a particular qualified benefit from the immediately preceding plan year, and who incurs expenses for that same qualified benefit during the grace period, may be paid or reimbursed for those expenses from the unused benefits or contributions as if the expenses had been incurred in the immediately preceding plan year. The effect of the grace period is that the participant may have as long as fourteen months and fifteen days (i.e., the twelve months in the current plan year plus the grace period) to use the benefits or contributions for a plan year before those amounts are "forfeited" under the "use-it-or-lose-it" rule.¹ (For the clarified Form W-2 reporting requirements, which apply when an employer has amended a cafeteria plan document to provide a grace period for qualified dependent care assistance immediately following the end of a cafeteria plan year, see Notice 2005-61).²

Coordination with Dependent Care Credit

The amount of employment-related expenses available in calculating the dependent care credit of IRC Section 21 is reduced by the amount excludable from gross income under IRC Section 129.³

Employer's Deduction

The employer's expenses incurred in providing benefits under a dependent care assistance program generally are deductible to the employer as ordinary and necessary business expenses under IRC Section 162.

Sole Proprietors and Partners

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer. A partnership is treated as the employer of each partner who is an employee under the plan.⁴ A self-employed individual (within the meaning of 401(c)(1)) is considered an employee.⁵

Reporting Requirements

An employee cannot exclude from gross income any amount paid or incurred by the employer for dependent care assistance unless the name, address, and taxpayer identification number of the person (name and address in the case of a tax-exempt 501(c)(3) organization)

1. Notice 2005-42, 2005-23 IRB 1204.

2. 2005-39 IRB 607, *amplifying*, Notice 89-11, 1989-2 CB 449.

3. IRC Sec. 21(c).

4. IRC Sec. 129(e)(4).

5. IRC Sec. 129(e)(3).

providing the services are included on the return. If this information was not provided, but the taxpayer exercised due diligence in attempting to do so, the amount shall not be included in the employee's gross income.¹

IRC Section 6039D generally requires an employer maintaining a dependent care assistance plan to file an information return with the IRS that indicates:

- (1) its number of employees;
- (2) the number of employees eligible to participate in the plan;
- (3) the number of employees participating in the plan;
- (4) the number of highly compensated employees ("HCEs") of the employer;
- (5) the number of HCEs eligible to participate in the plan;
- (6) the number of HCEs actually participating in the plan;
- (7) the cost of the plan;
- (8) the identity of the employer; and
- (9) the type of business in which it is engaged.

For plan years beginning prior to the issuance of further guidance from the IRS, these reporting requirements are suspended for dependent care assistance plans.²

1. IRC Sec. 129(e)(9).

2. Notice 2002-24, 2002-16 IRB 785; Notice 90-24, 1990-1 CB 335.