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IRS Issues Guidance on Taxation of DCAP Carryover Amounts

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4-Minute Read

The IRS recently issued [Notice 2021-26](#) to address the taxation of dependent care benefits, provided through a dependent care assistance program (DCAP) in taxable years ending in 2021 and 2022 due to the application of either the carryover or the extension of a claims period under the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (the Act), enacted as part of the Consolidated Appropriations Act on December 27, 2020 (CAA).

Under the Act, DCAPs may 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, the Act 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 for unused benefits remaining in the DCAP. The notice clarifies that if 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 benefits will not be taken into account for purposes of the application of the limits under Section 129 of the Internal Revenue Code (Code) to other dependent care benefits available for the taxable years ending in 2021 and 2022.

For 2020, the DCAP limit could not exceed \$5,000, or \$2,500 in the case of a separate return filed by a married individual. The American Rescue Plan Act of 2021 (ARP) increased the DCAP limit to \$10,500 for the taxable year beginning after December 31, 2020, and before January 1, 2022.

In order to take advantage of the increased limit, plans 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.



Notice 2021-26 contains the following examples intended to clarify the tax treatment of carryovers and claim extension periods. In the examples, the employee's taxable year is the calendar year and the employee is not a married individual filing separately. Consistent with current law, the examples assume that the Code Section 129 exclusion for the 2022 taxable year reverts to \$5,000.

Example 1

An employee is covered by a calendar year Section 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 Section 214 of the Act, the Section 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 Section 125 cafeteria plan that offers a DCAP benefit. The Section 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 Section 214 of the Act, the Section 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 Section 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 Section 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 Section 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 Section 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 Section 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 Section 214 of the Act.

Example 3

An employee is covered by a non-calendar-year Section 125 cafeteria plan that offers a DCAP benefit. The Section 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 Section 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 Section 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 Section 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 Section 129 of the Code. The remaining \$3,000 received by the employee is included in the employee's gross income and wages.

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