

Dependent Care Assistance Programs (DCAPs): Basics

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Section 129 of the tax code permits employees to exclude up to \$5,000 from gross income to pay for dependent care expenses. These arrangements, required to be established by a written document, are referred to as Dependent Care Assistance Programs (DCAPs). In many ways they function similarly to health flexible spending accounts (FSAs), so they are frequently referred to as “dependent care flex accounts.” In this issue brief, we will discuss the various rules to be aware of when implementing and administering a DCAP.

Participation

From a tax perspective, any common-law employee of the employer can participate in the employer’s DCAP. In addition, self-employed individuals are technically able to participate in a DCAP, but they are not permitted to participate in an employer’s Section 125 cafeteria plan. In other words, self-employed individuals (such as partners, sole proprietors, and more than 2% shareholders in a Subchapter S corporation) can receive employer contributions to a DCAP, but cannot elect to have pre-tax salary reductions in order to contribute to a DCAP. Permitting self-employed individuals to participate in a DCAP with employees who are eligible to contribute on a pre-tax basis requires that the separate funding methods be explained in the document that establishes the DCAP.

Employers can further limit eligibility to participate in a DCAP beyond simply being a common-law employee. Employers often limit eligibility to participate in a DCAP to full-time employees. If employers would like to open up participation in the DCAP to employees beyond those who work enough hours to be considered full-time, they should be sure that these employees are eligible to participate in the employer’s cafeteria plan so that they will be able to make contributions through pre-tax salary reductions.

Contributions

DCAPs allow either the employer or the employee to contribute funds to reimburse dependent care expenses on a tax-favored basis. Regardless of who makes the contributions, the annual contribution amount is limited to the lesser of: (i) \$5,000 for single individuals or married individuals filing joint tax returns (\$2,500 for married individuals filing separately) and (ii) the earned income of the employee/spouse. The limit always applies on a calendar year basis. Employers should report DCAP contributions in Box 10 on employees’ Forms W-2.

Employee contributions to DCAPs are made through the employer’s Section 125 cafeteria plan. Section 125 requires all employee contributions made under the cafeteria plan to be made on a uniform basis. Therefore, in most cases DCAP contributions are made ratably (equal contributions) throughout the plan year.

Employees can technically begin making contributions to a DCAP before they have any eligible expenses. For example, a person who is anticipating having to make childcare payments later in the year due to the birth of a child may elect to begin contributing to a DCAP at the beginning of the year. However, employees should be aware that once contributed, amounts cannot be removed from a DCAP unless they are for reimbursement of eligible expenses. Therefore, especially considering that the Section 125 regulations are relatively permissive when it comes to permitted midyear pre-tax election changes for DCAPs, it may be safer to delay contributions until the employee is able to use them. On the other hand, unlike health FSAs, DCAPs are not subject to the uniform coverage rule. In other words, an employee has access only to what they have already contributed to the DCAP for reimbursement.

Midyear Changes

Section 125 requires employees to decide, at the beginning of the coverage period, what they are going to contribute over the duration of the coverage period (plan year). Further, Section 125 permits changes to this election only upon the occurrence of certain events. In contrast to other benefits that can be offered under a Section 125 cafeteria plan, DCAP election changes are permitted under most circumstances.

Specifically, changes to DCAP elections are permitted when an employee experiences an event that affects the status of dependent care expenses under Section 129 of the tax code. If an employee experiences an event that is generally recognized under Section 125 that affects the employee's eligible DCAP expenses, the change is permitted. For example, if an employee's marriage affects the number of qualifying individuals for which the employee can submit DCAP expenses, a corresponding pre-tax election change would be permitted. In addition, if the employee experiences a change to the cost of child care, or changes childcare providers, a corresponding pre-tax election change would be permitted. (Keep in mind that employers can always design their Section 125 plans to permit changes in more limited circumstances than those permitted under the tax code.)

Eligible Expenses

To benefit from a DCAP, an employee must both be eligible to participate and have eligible expenses to submit for reimbursement. Eligible expenses are for the care of a qualifying individual. That care must enable the employee, as well as the employee's spouse, to be gainfully employed. In addition, the expense cannot also be claimed under the Dependent Care Tax Credit.

Qualifying Individual

An employee is permitted to submit care expenses under a DCAP only for "qualifying individuals."

Code §21(b)(1) includes three definitions for "qualifying individuals":

1. a dependent of the taxpayer who has not attained age 13;
2. a dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of such taxable year;
or
3. the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of such taxable year.

If an employee is unsure as to whether an individual can be treated as a qualifying individual for DCAP purposes, they should be advised to discuss the issue with a tax advisor. Qualifying individuals can include individuals beyond the employee's children. However, in all cases, to be considered a qualifying individual, the individual has to have the same principal place of abode as the employee for more than one-half of the taxable year for which the employee is attempting to use the DCAP. Special rules apply in the case of parents who are not married, because the child will be a qualifying individual for only one of the parents (assuming the child is a qualifying individual for either).

Gainfully Employed

Care expenses are eligible for reimbursement only if the care enables the employee and the employee's spouse to be gainfully employed or in active search of gainful employment. An expense does not necessarily enable a person to be gainfully employed in every situation in which an employee is in fact gainfully employed. In other words, care acquired for personal reasons is not considered care that enables an employee and their spouse to be gainfully employed. For example, an employee would not be permitted to submit babysitter expenses incurred while they go out to eat with their spouse to the employer's DCAP for reimbursement.

Both the employee and the employee's spouse must be either gainfully employed or actively searching for gainful employment to have any eligible DCAP expenses. For these purposes, both full-time and part-time employment can result in eligible DCAP expenses. However, employees working part-time are permitted to submit care expenses only for working days. However, if an employee is required to pay for a period that includes non-working days, the employee can submit the entire expense for reimbursement. There is little guidance regarding what expenses will be reimbursed in the case of an employee or spouse actively searching for gainful employment. These expenses should be evaluated on a case-by-case basis according to the specific facts and circumstances of the situation to determine whether the expense is enabling the employee or spouse to be gainfully employed.

Eligible Care Arrangement

Expenses are eligible for reimbursement only if the primary purpose of the expense is to assure the individual's

well-being and protection. Therefore, expenses for educational programs, such as tutoring, music lessons, or other similar programs, are generally not reimbursable even if the employee would have had to procure other care had it not been for the educational program. There is a limited exception to this general rule for certain summer day camps.

Several different types of care arrangements can be submitted for reimbursement under a DCAP. These care arrangements include daycare centers, in-home care (such as a nanny or au pair), custodial care, and, in some cases, backup/emergency care. If the care is provided by a tax dependent of the employee, the employee's child under the age of 19, the employee's spouse, or the qualifying individual's other parent who is not the employee's spouse, then the expense is not eligible for reimbursement.

Use-Or-Lose

Contributions are either used for reimbursement of care for qualifying individuals during the coverage period or forfeited (referred to as the use-or-lose rule). However, plans may allow a 2½-month grace period, during which time employees may still incur expenses and submit claims to the DCAP. But unlike health FSAs, DCAPs are not permitted to allow for a carryover of unused amounts from one plan year to the next. In addition, a DCAP may be designed to permit individuals who are no longer participants to spend down their contributions through the end of the current plan year if they still have eligible expenses.

Conclusion

If an employee is eligible to participate in their employer's Section 125 plan, they may elect to exclude up to the lesser of (i) \$5,000 for single individuals or married individuals filing joint tax returns (\$2,500 for married individuals filing separately) and (ii) the earned income of the employee/spouse to pay for dependent care expenses. If an employee experiences an event listed under Section 125, they can make a midyear pre-tax election change to their DCAP election. Eligible DCAP expenses are for the care of a qualifying individual that enables the employee, as well as the employee's spouse, to be gainfully employed. In general, contributions must be used during the plan year. However, employers can implement a 2½-month grace period and/or a spend-down provision.

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