Brown & Brown

EMPLOYEE BENEFITS

Dependent Care Assistance Plan (DCAP) Guide

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What Is a Dependent Care Assistance Plan (DCAP)?

Section 129 of the Internal Revenue Code (the "Code") allows an employer to provide tax-advantaged dependent care assistance benefits to its employees.[1] Employer-sponsored dependent care benefit programs provided to employees pursuant to the Code's requirements are typically referred to as Dependent Care Assistance Programs (DCAPs) or Dependent Care Flexible Spending Accounts (Dependent Care FSAs). Dependent Care FSAs are dependent care programs included in a Section 125 plan that generally include employee pre-tax contributions to an account from which reimbursements are provided for eligible dependent care expenses. DCAPs include Dependent Care FSAs and programs provided outside of a Section 125 plan, such as a program where an employer provides on-site dependent care for employees and a program where an employer pays a dependent care provider directly for care provided to employees' dependents. Both programs are subject to the tax rules found in Section 129.

Note: In this document, we use the term DCAP to refer to any dependent care benefits program sponsored by an employer for its employees.

[1] *These benefits are typically provided solely to common law employees of the employer. However, Section 129 authorizes certain self-employed individuals (including sole proprietors, partners, more-than-2% shareholders of a Subchapter S corporation, and others) to participate in a DCAP. Code §129(e)(3). Such self-employed individuals cannot participate in a Section 125 plan and cannot make pre-tax contributions to a DCAP. As a result, such individuals generally can participate only in a DCAP funded by the employer.*

INTERNAL REVENUE CODE REQUIREMENTS FOR DCAPs

Section 129 Requirements

In order for it to provide tax-free benefits to all of its participants, a DCAP must comply with several legal requirements under Code Section 129. These basic legal requirements, found within the Code, are as follows:

Written Plan Document and Exclusive Benefit Requirement:

Code Section 129 requires that a sponsoring employer adopt and maintain a written plan document that describes the DCAP and otherwise complies with the requirements of the section.[2] In addition, the DCAP must be established for the exclusive benefit of its employees.

Nondiscrimination Requirements:

Under Code Section 129, DCAP benefits provided to highly compensated employees will be tax-free only if the DCAP does not discriminate in favor of highly compensated employees.[3] For purposes of Code Section 129's nondiscrimination rules, "highly compensated employees" are employees who earned in excess of a certain indexed income threshold[4] in the preceding plan year or who are more than 5% owners in the current or preceding plan year.[5]

DCAPs are subject to four separate tests under Code Section 129's nondiscrimination rules: 1) the eligibility test; 2) the contributions and benefits test; 3) the more-than-5% owner concentration test; and 4) the 55% average benefit test.

Eligibility Test. A DCAP's eligibility provisions may not discriminate in favor of highly compensated employees.[6] If all employees are eligible to participate in the DCAP, the plan will automatically pass the eligibility nondiscrimination requirement. If not all employees are eligible, the DCAP must pass the nondiscriminatory classification test under Code §410(b). Under that test, a DCAP generally will not be discriminatory with respect to eligibility if (1) the plan benefits employees who qualify under a reasonable classification established by the employer based on objective business criteria and (2) the classification of eligible employees is nondiscriminatory based on a percentage test.

Contributions and Benefits Test. The contributions and benefits provided under a DCAP may not discriminate in favor of highly compensated employees or their dependents.[7] This requirement is not based on utilization of benefits but requires a facts-and-circumstances analysis to determine whether highly compensated employees or their dependents are offered better benefits or the same benefits but on better terms.

More-than-5% Owner Concentration Test. Additionally, no more than 25% of the amounts paid or incurred by the employer for dependent care during a plan year may be provided to shareholders or owners (or their spouses/dependents) who own more than a 5% interest in the employer.[8]

55% Average Benefits Test. Lastly, the average DCAP benefit provided to non-highly compensated employees must be at least 55% of the average benefit provided to highly compensated employees.[9] This requirement focuses on the per-employee benefit received by highly compensated employees as compared to the per-employee benefit received by non-highly compensated employees. In general, all employees are considered when calculating the average per-employee benefit, regardless of whether they are eligible for and/or participating in the DCAP.[10]

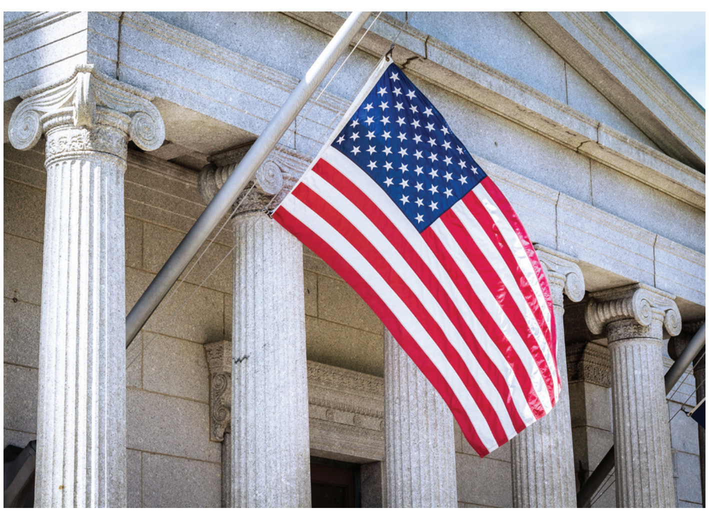
[2] *Code §129(d)(1).*
[3] *Id.*
[4] *The indexed income threshold is the same that applies for 401(k) plan nondiscrimination testing. See https://www.irs.gov/retirement-plans/plan-participant-employee/definitions#:~:text=For%20the%20preceding%20year%2C%20received,top%2020%25%20of%20employees%20when.*
[5] *Code §129(d)(2)-(3).*
[6] *Code §129(d)(3).*
[7] *Code §129(d)(2).*
[8] *Code §129(d)(4).*
[9] *Code §129(d)(8).*
[10] *If the DCAP is funded with salary reduction contributions, employees earning less than $25,000 may be excluded from this calculation. Code §129(d)(8)(B). In some cases, employees who have not attained age 21, who have not completed a year of service, or who are collectively bargained may also be excluded. Code §129(d)(9).*

If in a particular plan year a DCAP discriminates in favor of highly compensated employees in any way, no DCAP benefits provided to the highly compensated employees for that plan year are excludable from taxable income under Section 129. All benefits provided to highly compensated employees will need to be included in their gross income and reported as wages in Box 1 of IRS Form W-2. Due to this adverse consequence, many employers will conduct a pre-test (primarily for the 55% Average Benefits Test) early in the plan year to determine the likelihood of the DCAP passing the test(s). If it appears the DCAP might not pass a test, adjustments may be made prior to the end of the plan year to help the DCAP pass the test for the plan year. For instance, if the average benefits elected by highly compensated employees is too high (and it appears the DCAP will not pass the 55% Average Benefits Test), the employer typically can reduce the elections of the highly compensated employees (if authorized by the Section 125 plan) so the DCAP is more likely to pass the test.[11]

If the DCAP takes the form of pre-tax salary reductions offered through a cafeteria plan pursuant to Section 125, additional nondiscrimination requirements will apply (see below discussion of Section 125 rules applicable to DCAPs).

Disclosure Requirements:

Code Section 129 provides that an employer must provide "reasonable notification" of the availability and terms of its DCAP to its employees.[12]



Eligible Expenses:

The terms of the DCAP, as described in the plan document, must permit the reimbursement of dependent care expenses for qualifying individuals, as defined later in this document, and the expense must be considered an "employment-related expense" under the regulations.[13]

"Employment-Related Expense" Requirement:

For DCAP purposes, an "employment-related expense" is an expense that an employee incurs in order to enable the employee (and the employee's spouse) to be "gainfully employed" and is for the "care" of one or more "qualifying individuals".[14]

"Gainfully Employed"

Whether the purpose of an expense is for an individual to be "gainfully employed" is a facts-and-circumstances determination. The regulations provide the following regarding what may or may not be considered an expense that enabled an individual to be "gainfully employed":

> *Expenses are employment-related expenses only if they are for the purpose of enabling the taxpayer to be gainfully employed. The expenses must be for the care of a qualifying individual or household services performed during periods in which the taxpayer is gainfully employed or is in active search of gainful employment. Employment may consist of service within or outside the taxpayer's home and includes self-employment. An expense is not employment-related merely because it is paid or incurred while the taxpayer is gainfully employed. The purpose of the expense must be to enable the taxpayer to be gainfully employed. Whether the purpose of an expense is to enable the taxpayer to be gainfully employed depends on the facts and circumstances of the particular case. Work as a volunteer or for a nominal consideration is not gainful employment.*[15]

[11] The IRS has not provided formal guidance regarding such adjustments. A couple of approaches are possible. If the issue is discovered late in the year, the reduction in elections may create a need to recharacterize benefits already paid as taxable income. Employers wishing to make mid-year changes to address a nondiscrimination claim may want to discuss specific approaches with legal counsel.
[12] Code §129(d)(6).
[13] Code §129(e)(1).
[14] Code § 21.
[15] Treas. Reg. §1.21-1(c)(1).

Under the regulations, an employee's spouse who is a full-time student or incapable of self-care (and lives at the employee's home for more than half the year) is considered to be gainfully employed.[16]

In most cases, whether an expense was incurred to enable an employee and their spouse to be gainfully employed is determined daily. Under this general rule, expenses incurred for care provided during a day on which the employee and spouse are not working typically would not be eligible expenses. For example, an employee on a leave of absence generally will not have eligible dependent care of expenses during the leave because the expenses have not been incurred to enable the employee to work.

The regulations contain two exceptions to the general rule discussed in the foregoing paragraph[17]:

- Short, Temporary Absences from Work. An employee "is not required to allocate expenses during a short, temporary absence from work, such as for vacation or minor illness, provided that the care-giving arrangement requires the [employee] to pay for care during the absence. An absence of 2 consecutive calendar weeks is a short, temporary absence. Whether an absence longer than 2 consecutive calendar weeks is a short, temporary absence is determined based on all the facts and circumstances."
- Part-Time Employment. A part-time employee "generally must allocate expenses for dependent care between days worked and days not worked. However, if a [part-time employee] is required to pay for dependent care on a periodic basis (such as weekly or monthly) that includes both days worked and days not worked, the taxpayer is not required to allocate the expenses. A day on which the taxpayer works at least 1 hour is a day of work."

"Care"

The regulations provide that expenses will be considered for the "care" of a qualifying individual "if the primary function is to assure the individual's well-being and protection."[18] However, this will not include"[a]mounts paid for food, lodging, clothing, or education" unless they are inseparably linked to "care" expenses.[19] Typical examples of arrangements that qualify as "care" are the services of babysitters, dependent care centers and family daycare centers.

"Care" does not include educational expenses (kindergarten and above) as the "primary function" of schooling is considered to be "educational" rather than "care" for a child. However, the regulations specifically state that preschool and nursery school expenses are considered "care" and are thus eligible DCAP expenses.[20]

Other expenses that may qualify as "care", and thus be reimbursable under a DCAP, include expenses for day camps[21] (even if the day camp specializes in an activity, e.g., soccer) and transportation costs where the dependent care provider provides the transportation.[22]

"Qualifying Individual"

The regulations provide that qualifying individuals are:

> (i) The taxpayer's qualifying child (as defined in Code Section 152) who has not attained age 13;
>
> (ii) The taxpayer's qualifying child or qualifying relative (using modified definitions of those found in Section 152) "who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year;" or
> (iii) a taxpayer's spouse "who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year."[23]

[16] *Treas. Reg. §1.21-2(b)(4).*
[17] *Treas. Reg. §1.21-1(c)(2).*
[18] *Treas. Reg. §1.21-1(d)(1) (emphasis added).*
[19] *Id.*
[20] *See Treas. Reg. §1.21-1(d)(5).*
[21] *Summer school is considered primarily educational in nature and expenses for summer school are not reimbursable by a DCAP. Treas. Reg. §1.21-1(d)(6). Similarly, the cost of overnight camps is not considered employment-related expense and is not reimbursable.*
[22] *Treas. Reg. §1.21-1(d)(7)-(8).*
[23] *Treas. Reg. §1.21-1(b)(1).*

Claims Substantiation Requirement

Under IRS regulations, reimbursement for dependent care expenses cannot be provided prior to the expense being incurred.[24] Dependent care expenses are incurred when the dependent care is provided.

Furthermore, DCAP claims must be substantiated through "information from a third-party that is independent of the employee and the employee's spouse and dependents."[25] The information provided by the independent third-party must include a description of the service, its date and the amount of the expense.

Debit Card Reimbursement Rules

IRS regulations allow for the use of DCAP debit cards.[26] However, the substantiation requirements described above create a practical issue if the care provider charges an up-front amount that must be paid in advance of services. To provide some relief regarding this issue, the IRS has provided a "rolling funding" method for DCAP debit cards based on expenses previously incurred.[27] The process is as follows:

1. **Initial Substantiation of Qualifying DCAP Expense**
   - The employee initially pays for a qualifying expense without using a DCAP debit card and provides substantiation for the expense.
2. **Initial Debit Card Funding**
   - After the expense has been incurred and substantiated, the plan makes available funds on the DCAP card for the lesser of:
     a. The previously incurred and substantiated expense; or
     b. The employee's year-to-date DCAP contribution amount.
3. **Employee Uses Debit Card Funds for Subsequent Expenses**
   - With the funds loaded on the card from the initial expense, the employee can use the funds to pay the cost for the next period of care from the same provider. Transactions that match the same provider and time period are also substantiated without further review, assuming the amount is equal to or less than the previous substantiated amount.

Limit on Tax Exclusion

The amount of dependent care assistance an individual can exclude from income for federal tax purposes is limited by Section 129.[28] The limit is not indexed for inflation and is based on a calendar year rather than a plan year. The limit is **the lesser of:**

- $5,000 (only for single individuals or married couples who file their taxes jointly);
- $2,500 (only for married individuals who file their taxes separately);
- The employees' earned income for the year; or
- If the employee is married, their spouse's earned income for the year.[29]

For a married couple that files taxes jointly, it is important to emphasize that the $5,000 limit is a shared limit – not a limit that applies to each spouse individually. If each spouse participates in a DCAP at their respective employers, their combined limit is $5,000.

[24] Prop. Treas. Reg. §1.125-6(a)(4).
[25] Prop. Treas. Reg. §1.125-6(b).
[26] Prop. Treas. Reg. §1.125-6(g).
[27] IRS Notice 2006-69.
[28] Code § 129(a)(2) and 129(b).
[29] Note, under the regulations, an employee's spouse who is a full-time student or incapable of self-care (and lives at the employee's home for more than half the year) is considered to be gainfully employed and to have an earned income of, not less than (a) $250 per month.

Because the tax exclusion generally operates on a calendar year basis based on when the reimbursed dependent care expenses were incurred, non-calendar-year DCAPs complicate the application of the maximum tax exclusion.[30] The following example can most easily illustrate this issue:

> A DCAP operates on a 7/1 to 6/30 plan year. A single employee gives birth to a baby in December and enrolls in the DCAP in January 2024, electing $3,500 in DCAP benefits. The employee uses the total of $3,500 to pay for care received between 1/1 and 6/30/24. For the new plan year starting 7/1/24, the same employee elects $5,000 and uses $2,500 to pay for care received between 7/1 and 12/31/24. Although the employee has not elected in excess of $5,000 for any plan year, the total amount of benefits received in 2024 is $6,000. This would result in $1,000 of the benefits being taxable.

When an employer offers an employer-funded dependent care program in addition to the DCAP included in the Section 125 plan, an employee's limit under Section 129 will be reduced by the fair market value of dependent care services received by the individual through the employer-funded program.[31] Employer-funded programs include on-site dependent care facilities provided to employees at no charge and programs where an employer pays a dependent care provider directly for care provided to employees' dependents (e.g., an emergency daycare program).

Section 125 Requirements

A DCAP is typically funded through a salary reduction arrangement under a cafeteria plan. Accordingly, in addition to Code Section 129 requirements, most DCAPs will also be subject to certain Section 125 requirements (to the extent it is part of a cafeteria plan).

Election Change Rules

Code Section 125 provides that unless a specific exception (enumerated in the regulations) applies, a pre-tax election, once made, must remain in effect for the entire plan year. This is referred to as the "irrevocable election rule." The rule applies to DCAP elections made under a Section 125 cafeteria plan.

The IRS regulations permit (but do not require) cafeteria plans to be drafted to allow DCAP election changes in certain circumstances. In general, these will include:

> **Change in Status Events:**
>
> Many status change events described under the Section 125 regulations allow for a DCAP election change, assuming the requested change is consistent with the event. Examples include a change in the number of dependents (e.g., increasing a DCAP election when adopting a dependent), a change in the employment status of the employee or spouse (e.g., commencing DCAP participation due to previously unemployed spouse finding work and now unable to care for the child), or a dependent losing eligibility.
>
> **Change in Cost and Coverage:**
>
> Certain changes in cost and coverage of DCAP-eligible expenses allow an individual to change their election mid-year. A plan can permit a mid-year election change when there is a change in cost for a dependent care provider, when a participant changes providers or when the amount of care needed changes.[32]
>
> **FMLA Leave:**
>
> Employees who take leave under the FMLA can revoke elections for non-health benefits to the same extent employees who take non-FMLA leave can under a cafeteria plan.[33]

[30] Non-calendar year DCAPs can raise other issues including incorrect W-2 reporting of DCAP benefits (because this reporting is based on the calendar year) and possible nondiscrimination testing issues (if testing is performed on a calendar year basis).
[31] See IRS Notice 90-66.
[32] See Treas. Reg. §1.125-4(f)(6), Examples 5 and 6. Note, however, that an election change is not allowed due to a cost change when the dependent care provider is a relative of the employee. Treas. Reg. §1.125-4(f)(2)(iv).
[33] This assumes the employee remains eligible for the DCAP during the FMLA leave. Under some plans, employees who are not working cease to be eligible for the DCAP.

"Use-or-Lose" Rule

DCAPs are subject to the cafeteria plan "use-or-lose" rule. The rule provides that, in general, a cafeteria plan cannot permit employees to carry over unused DCAP contributions from one plan year to the next and that any remaining contributions at the end of the plan year, or upon the termination of participation, must be forfeited unless an exception applies.[34]

Exceptions to the "use-or-lose" rule include grace and run-out periods. A grace period refers to a period of up to two months and 15 days after the close of a plan year, in which a cafeteria plan allows employees to use remaining funds after the plan year's end to pay or reimburse newly incurred expenses. A run-out period refers to a period after the plan year ends (or participation terminates) during which employees may submit claims for reimbursement of expenses incurred during the plan year. A DCAP plan may have both a grace period and a run-out period. DCAPs cannot, however, have a carryover feature.

A special rule allows DCAPs to continue reimbursing expenses incurred after participation in the DCAP would otherwise end (e.g., upon the termination of employment). A DCAP can be designed to allow a former participant to "spend down" any existing account balance until the end of the plan year by submitting claims to reimburse eligible expenses incurred after the participant ceased to be eligible.

DCAP account balances remaining after the end of a plan year, any applicable grace period, and the plan's run-out period must be forfeited.[35] The Section 125 regulations provide that such forfeitures may either be retained by the employer or used by the employer "only in one or more of the following ways—

> (A) To reduce required salary reduction amounts for the immediately following plan year, on a reasonable and uniform basis, as described in [the regulations];
>
> (B) Returned to the employees on a reasonable and uniform basis, as described in paragraph (o)(2) of this section; or
>
> (C) To defray expenses to administer the cafeteria plan."[36]

Section 125 Nondiscrimination Requirements

In addition to the nondiscrimination requirements of Section 129 that apply to all DCAPs, DCAPs that are part of a cafeteria plan will also be subject to Section 125's nondiscrimination rules. Under the Section 125 nondiscrimination rules, the benefits provided by the DCAP will be considered when applying the Section 125 nondiscrimination tests that address benefit utilization. Specifically, that includes the key employee concentration test and the utilization component of the contributions and benefits test.

Tax Reporting Requirements

Employers who sponsor a DCAP program must report the total amount of DCAP benefits provided to each employee on Box 10 of the employee's IRS Form W-2 (including any amounts in excess of the DCAP exclusion amount).

The amounts reported in Box 10 must include:

- All amounts reimbursed in cash, such as amounts reimbursed through salary reduction under a cafeteria plan;
- The fair market value of employer-provided benefits (e.g., on-site daycare); and
- Amounts paid directly to a provider by an employer (to subsidize the employee's costs).

If the employer provides DCAP amounts over the employee's DCAP maximum, those excess amounts must also be reported in Box 1, Box 3 and Box 5 on the employee's Form W-2.

Employees who receive DCAP benefits are also required to report certain information (including information about the daycare provider) on their personal tax returns via Form 2441.[37]

ERISA, COBRA, HIPAA, Healthcare Reform and HSA Eligibility

In most cases, DCAPs are not ERISA welfare benefit plans.[38] Accordingly, most DCAPs are not subject to ERISA's various requirements for welfare plans (e.g., SPD, Form 5500 reporting, etc.). An exception applies, however, to employer-sponsored daycare centers (on-site or off-site). Such benefits are considered to be an ERISA welfare plan. However, employer-sponsored day-care centers are exempt from the Form 5500 requirement (regardless of the number of participants) and most ERISA disclosure obligations (e.g., SPD requirement).[39]

Assuming it does not provide any medical benefits, a DCAP will not be a group health plan and will not be subject to COBRA, HIPAA or the ACA (Healthcare Reform). Furthermore, participation in a DCAP will not affect an individual's HSA eligibility.

34 Prop. Treas. Reg. §1.125-5(c)(1).
35 Prop. Treas. Reg. §1.125-1(f).
36 Prop. Treas. Reg. §1.125-5(o)(1).
37 Code 129(e)(9).
38 DOL Advisory Opinion 93-25A.
39 DOL Reg. §2520.104-25.

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