

Dependent Care Reimbursement Accounts

Under a dependent care assistance plan (DCAP), employees can exclude from their income amounts paid (or expenses incurred on their behalf) by their employer for certain types of care provided to children and other dependents. The basis for this favorable tax treatment of DCAPs is found in Section 129 of the tax code.

To qualify under the Section 129 rules, an employee's expense for dependent care must be employment-related, meaning that the care is required so that the employee-and spouse, if the employee is married-can be at work. Generally, employees cannot participate in a DCAP unless their spouses are employed (see "Maximum reimbursement," below). It does not matter whether employment is on a part-time or a full-time basis.

Dependent care FSAs essentially operate in the same way as health FSAs. Each year, an employee may elect how much to contribute for qualified dependent care expenses. As these expenses are incurred, the employee requests that reimbursements be made from his or her dependent care FSA. Dependent care FSAs must comply with the same Section 125 rules that govern health FSAs, except for one important exception: The uniform reimbursement requirement does not apply to dependent care FSAs.

Maximum reimbursement amount

Under Section 129, pre-tax reimbursements of employment-related qualified dependent care expenses cannot exceed a certain amount for the plan year. The maximum reimbursement is the lowest of the following:

- (1) the employee's earned income (including wages and earnings from self-employment) for the plan year;
- (2) the spouse's earned income for the plan year; or
- (3) \$5,000 (or \$2,500 for married employees who file separate tax returns).

The second element of this rule effectively prohibits an employee from participating in a DCAP if the employee's spouse is unemployed.

A special rule applies, however, in the case of spouses who are full-time students or are incapable of caring for themselves. If a spouse meets either one of those two criteria and has no earned income, that spouse is treated as if he or she did earn income in any month in which the applicable criterion was met. The amount of this "deemed" earned income will be either \$200 per month if the employee has one dependent, or \$400 if the employee has two dependents.³

For identification purposes, a person is considered married if he or she is married at the end of the plan year. If an employee and his or her spouse participate in separate DCAPs, their combined exclusion under both plans is still limited to \$5,000. For example, assume that Roger and Becky Jones both participate in their respective employers' DCAPs. They incur \$7,500 in eligible dependent care expenses for their two-year-old. If Roger and Becky file jointly, their combined tax exclusion under the two DCAPs cannot exceed \$5,000. If Roger and Becky file separately, each can exclude up to \$2,500.

Definition of an eligible dependent

An eligible dependent is defined as any person who can be claimed by an employee as a dependent for federal tax purposes (under Section 151(c) of the tax code) and who: is under age 13; requires full-time care because of physical or mental incapacity (for example, a disabled spouse or parent); or is the spouse of the employee and is physically or mentally incapable of caring for himself or herself.

Expenses for care provided outside a taxpayer's home may be claimed only for dependents under age 13 or other dependents who regularly spend at least eight hours per day in the taxpayer's home. For example, full-time care in a nursing home for a dependent parent would not qualify. Also, expenses incurred during a plan year after a child attains age 13 are not reimbursable.

Definition of qualified care provider

Payments for dependent care services provided by dependents of either the taxpayer or the taxpayer's spouse, or to a child of the taxpayer who is under age 19, do not qualify under a DCAP. Thus, for example, a payment made by an employee to her 15-year-old daughter for baby sitting a sibling would not be qualified, nor would payments for child care made to an employee's parent if that parent is claimed as a dependent by the employee.

Expenses incurred for care at a child care center are qualified only if the center:

provides care for more than six individuals (other than those who reside at the facility); .receives a fee, grant or payment for providing these services to any individual; and complies with all applicable state and local laws.

Qualified expenses

Most importantly, a qualified expense must enable the employee (and spouse, if married) to be gainfully employed or to look for gainful employment. Volunteer work is not considered gainful employment. Beyond that requirement, numerous standards apply in determining a qualified expense.

Schooling. As noted above, the purpose of qualified dependent care assistance is help pay for care for a qualifying individual so that a parent or guardian can be gainfully employed or can look for a job. In most cases, this means care for a child so that a parent can work. Only custodial expenses -those related to a child's protection and well-being -may be reimbursed under a dependent care FSA; expenses that are educational in nature do not qualify. In addressing the definition of educational expenses, the relevant IRS regulations specify two standards:

(1) the full amount paid to a nursery school is considered a qualified expense (even if the nursery school provides educational services); and
(2) educational expenses for a child in first grade or above are not qualified expenses. Although the regulations do not address enrollment in kindergarten, an information letter issued by the IRS in September 2000 indicated that kindergarten expenses are generally for education, not custodial care. Thus, the appropriate standard seems to be that in the setting of a school or educational facility, only nursery school expenses should be reimbursed through a dependent care FSA.

Camps and babysitting. Summer day camp expenses qualify as eligible expenses, but over- night camp expenses do not. Generally, evening babysitting would not qualify as an eligible expense unless a single parent or both married parents work in the evening.

Transportation, entertainment and food. Qualified expenses only include the cost of services for the dependent's well-being and safety; they do not include the cost of transportation, entertainment, food or clothing unless such items are incidental and cannot be separated from the cost of the care provided. This means that the cost of getting a child or other qualifying dependent from home to a care provider, or from school to a care provider, is not a qualified expense.

Public transportation fares, such as for travel by bus, subway or taxi, are not qualified expenses, nor are any costs associated with operating a private car. This rule applies to providers as well as dependents-that is, transportation costs associated with bringing a care provider to an employee's home are not qualified expenses.

Household expenses. Expenses paid for household services are qualified if they:

- (I) pertain to services provided in the employee's home that are "ordinary and usual" and "necessary to the maintenance of the household" (such as a maid, housekeeper or cook); and
- (II) are attributable at least in part to the care of the qualifying individual. The services of a gardener or chauffeur, for example, would not qualify as eligible expenses.

Payroll taxes. Payment of payroll taxes by an employee in connection with compensation paid to a service provider is a qualified expense. These taxes include Social Security (FICA)/Medicare tax, federal unemployment tax (FUT A) or similar state payroll taxes.

Employee reporting requirement

Under Section 129, employees must report their DCAP benefits on their federal income tax returns. For this purpose, Section 129 also requires employers to provide each employee who participates in a DCAP with a written statement (by January 31 each year) showing the total amount of dependent care assistance expenses incurred by that employee during the previous calendar year.

Consideration of Available Income Tax Credits

Before an employee elects to use a dependent care FSA, he or she must determine whether using the dependent care child credit would be more beneficial. Generally, under Section 21 of the tax code, a credit against federal income tax may be available to a taxpayer for certain costs incurred for the care of "qualifying individuals," if such expenses are incurred so that the taxpayer may be gainfully employed. The credit is 30 percent of the employment-related childcare expenses, reduced by 1 percent for each \$2,000 (or fraction thereof) of adjusted gross income in excess of \$10,000, in no event may the credit be less than 20 percent of those expenses. (The annual credit will be 20 percent for taxpayers whose adjusted gross income exceeds \$28,000.) The annual amount of employment-related expenses that can be taken into account may not exceed \$2,400 if there is one "qualifying individual," or \$4,800 if there are two or more qualifying individuals. Employment-related expenses also are limited to the taxpayer's earned income or, if he or she is married, the lesser of the taxpayer's earned income or the earned income of his or her spouse.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), signed into

law on June 7, 2001, will increase the dependent care tax credit. EGTRRA increases the credit for the care of one qualifying individual to \$3,000 and the credit for the care of two or more individuals to \$6,000. These changes become effective for dependent care services rendered during taxable years beginning on or after Jan. 1, 2003.

However, employees cannot receive the full tax advantage of both the exclusion from income under Section 129 *and* the tax credit under Section 21. Instead, amounts funded through a dependent care FSA directly offset the maximum amount to which the tax credit can be applied.²¹ Additionally, to obtain the benefit from either the tax credit or the Section 129 exclusion, a taxpayer must file IRS Form 244.1, providing the name, address and taxpayer identification number (TIN) of the service provider. Care providers who fail to provide the correct TIN to the taxpayer may be penalized \$50 for each violation.²³

Employees must decide which of the two tax-saving options is more effective. In general, families with a combined taxable income of more than \$24,000 a year will benefit more from using the dependent care FSA. However, other factors, such as the number of children, marital status, adjusted gross income, itemized deductions, personal exemptions and the amount of money paid for child care must also be considered.

To illustrate how each plan works, consider a family with one child, adjusted gross income of

\$60,000, taxable income of \$40,000 and annual day care expenses of \$3,500 -or about \$67 a week. The tax credit for that family would be 20 percent of \$2,400 (the maximum expense allowed for one child) or \$480. However, the spending account would produce total tax savings of about \$1,248 (\$3,500 times 35.65 percent, the 28-percent income tax rate plus the 7.65-percent Social Security tax rate).

In the case of a couple with one child, adjusted gross income of \$22,000, no itemized deductions and annual child-care expenses of \$2,500 (or \$48 a week), the tax credit would be 24 percent of \$2,400, or \$576. The spending account would produce a total savings of about \$566 (\$2,500 times 22.65 percent, a .15-percent marginal income tax rate plus the 7.65-percent Social Security tax rate). In this case, the family would save \$.10 more by using the tax credit.

(Note: Neither example above takes into account state taxes. However, both factors should be taken into account when making individual determinations.)

Dependent Care FSA Rules

Dependent care FSAs operate pursuant to rules similar to health FSAs, with one important exception -dependent care FSAs are not subject to the uniform reimbursement requirement. This exception is not as generous as it first may seem. This is because dependent care expenses are usually incurred on a periodic basis, with expenses being incurred on a fairly level basis. Unlike health FSAs, it would be customary for a participant to incur significant dependent care expenses in advance of dependent care FSA contributions. Expenses should track contributions fairly closely, except perhaps during holidays or summer vacations.

Use-it-or-lose-it requirement

As with health FSAs, dependent care FSAs are subject to the "use-it-or-lose-it" rule. This is probably the most significant of the dependent care FSA rules and the one most relevant to employees. Thus, amounts set aside by an employee into a dependent care FSA that are not used by the end of the year are lost. Unused amounts cannot be paid in cash or any other benefit. This is true whether the dependent care FSA is funded with salary deferrals or employer compensation in addition to normal salary. In determining whether the use-it-or-lose-it rule is satisfied, consideration will be given to arrangements outside the cafeteria plan, such as increased compensation or benefits in an amount equal to or approximating the unused reimbursements.