

IRS Issues Proposed Regulations Governing DCAPs

The IRS recently published proposed regulations that affect which expenses can be reimbursed tax-free by an employer-sponsored dependent care spending account (DCAP). DCAPs usually are offered as cafeteria plan benefits, and are also often referred to as dependent flexible spending accounts, or dependent FSAs. The new guidance, which can be relied upon immediately, describes what expenses are eligible for the dependent care tax credit (DCTC) under the Internal Revenue Code (IRC). The guidance affects DCAPs because DCAPs generally can reimburse expenses that would qualify for the DCTC. In general, the proposed rules have pulled together a variety of rules and other guidance that have been introduced since the rules were originally issued 22 years ago. The proposed rules also provide important clarifications with respect to certain key issues.

Background

DCAPs can provide tax-free reimbursement of certain household and dependent care expenses which generally are necessary for the employee and the employee's spouse to be gainfully employed. The expenses must be for the care of one or more qualifying individuals identified in the DCAP plan document. Qualifying individuals may include an employee's dependent child who has not yet attained age 13. The tax code stipulates the requirements that a child must meet in order to qualify as an employee's dependent child for this purpose. Among other things, the child must have the same principal place of abode as the employee for more than one-half of the tax year. Qualifying individuals also may include the employee's spouse or dependent of any age who is physically or mentally incapable of self care and has the same principal place of abode as the employee for more than one-half of the year. Strict rules apply which define the "incapable of self care" standard. In addition, complicated rules apply to determine which individuals qualify as an employee's dependent for this purpose. To be eligible for tax-free reimbursement under a DCAP, the expenses must be "primarily for household service or for the care of a qualifying individual." The new proposed regulations provide guidance on this point.

Educational and Day Camp Expenses

Expenses are considered primarily for care if the principal nature of the services is to ensure the qualifying individual's well-being and protection. Amounts paid for food, lodging, clothing, or education, therefore, would *not* be for the care of the qualifying individual and would *not* be reimbursable under a DCAP. If the expenses are incidental to — and inseparably part of — the care provided, though, the entire expense is deemed to be for care and would be reimbursable.

Under the proposed rules, expenses for pre-school and other programs below the kindergarten level are deemed to be for care even if education comprises a significant portion of the program. The rules also make clear that expenses for programs at the kindergarten level and above are primarily for education. Therefore, those expenses generally are not reimbursable under a DCAP.

Expenses for day camps and other similar programs — even if the camps specialize in a particular activity (e.g. computers, sports, etc.) and include educational or meal components — may be reimbursable by a DCAP. By contrast, expenses for overnight camps are not reimbursable, even though they might include a component that would be deemed care of a qualifying individual.

Incidental Expenses

Transportation costs to and from the place where care is provided (e.g., travel to a day camp or to an after-school program) may be reimbursable if provided by the dependent care provider. If transportation is provided by anyone else, it would not be considered to be for care of the qualifying individual and the cost would *not* be reimbursable.

If an employee pays wages to a dependent care provider and the wages are reimbursable expenses, the employment

taxes that the employee must pay in regard to the wages will also be considered eligible for reimbursement. The additional cost of providing room and board to a caregiver that is above usual household costs may also be reimbursed (assuming that the cost for the caregiver's services is reimbursable).

Any expense that indirectly relates to an individual's care (such as application fees and deposits) may only be reimbursed if the employee is required to pay the expense to obtain the care. Deposits that are forfeited, as well as other similar payments that do not result in care actually being provided, are not treated as being related to a qualifying individual's care.

Household Services

If an expense is partly for household services and partly for the care of a qualifying individual, the employee must make a reasonable allocation between the eligible and ineligible expenses. Allocation is not required, though, if the household expense is "minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services."

Accounting for Absences from Work

A DCAP generally cannot provide tax-free reimbursement of dependent care expenses incurred while the employee was not engaged in gainful employment or actively looking for employment. When an employee is absent from work or works part-time, the rules generally require that dependent care expenses be allocated on a daily basis.

Under the new proposed rules, if an employee is *required* to pay for dependent care expenses on a weekly (or longer) basis, then allocation between days worked and days not worked may not be required. For example, if an employee were absent from work for a short period of time due to a minor illness, the proposed rules would still allow reimbursement of the full weekly or monthly charge. Similarly, an employee who works part-time would be required to allocate expenses between days worked and days not worked if it was necessary to pay for dependent care expenses on a weekly or monthly basis.

Marital Status and Payments to Related Individuals

A DCAP cannot provide tax-free reimbursement of payments that are made to a taxpayer's dependent or child under age 19 (e.g. paying an older child to "baby sit" a younger sibling). On the other hand, if the caregiver is a relative but *not* the taxpayer's dependent, then the payments to such person may qualify. Payments to the taxpayer's spouse, or to the parent of the taxpayer's child

who is not the taxpayer's spouse also do not qualify for the credit.

Divorce and Custody

In the case of a child of divorced or separated parents, only the custodial parent may receive tax-free reimbursement under a DCAP. This rule applies regardless of which parent is permitted to claim the dependency exemption on his or her income taxes or is financially responsible for providing the care.

The rules require that the care enable the employee to be gainfully employed. If the child does not live with the employee, then the care, even if required by law, is not necessary for the employee's gainful employment. No relief from this rule is provided for the non-custodial parent — even if the child lives with the non-custodial parent for a substantial amount of time during the year. When parents share custody, the custodial parent for purposes of the dependent care rules is determined by which parent has child custody for the greater portion of that year.

Conclusion

Although the new proposed regulations center on requirements connected to the DCTC, the requirements for DCAPs are very similar. The IRS' new guidance provides clarification for a variety of issues that should make administration of DCAPs easier. We caution readers to note that these regulations were published as "proposed guidance" and are therefore subject to change. Nonetheless, the regulations may be relied upon immediately.

For DCAPs, this means that the proposed regulations can probably be used for the current plan year if the definition of eligible dependent care expenses used in the plan document makes reference to employment-related expenses under IRC §21.

It is important to note that the tax code limits the amount of expenses that can qualify for the DCTC or be reimbursed under a DCAP. These statutory limits are discussed in detail in *Willis' On-line Compliance Manual*.

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