IRS Issues Guidance on Taxability of DCAP Benefits for 2021, 2022

On May 10, 2021, the Internal Revenue Service (IRS) released guidance on the taxability of dependent care assistance programs (DCAPs) for 2021 and 2022, clarifying that amounts attributable to previously issued carryover and extended grace period relief generally are **not taxable**.

Specifically, if these dependent care benefits would have been excluded from income if used during taxable year 2020 (or 2021, if applicable), these benefits will **remain excludible** from gross income and are not considered wages of the employee for 2021 and 2022. They will also generally **not be taken into account** for purposes of applying the exclusion limits of Internal Revenue Code Section 129.

Example

IRS Notice 2021-26 clarifies the interaction of this standard with the one-year increase in the exclusion for employer-provided dependent care benefits from $5,000 to $10,500 for the 2021 taxable year under the American Rescue Plan Act:

FACTS: Employee elects to contribute $5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during that plan year. The employer amends its plan to allow 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, incurs $15,500 in dependent care expenses for that plan year, and is reimbursed $15,500 by the DCAP.

CONCLUSION: 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 by the previously issued coronavirus-related relief.

General Rules

- Carryovers of unused DCAP amounts typically are not permitted, although a 2½ month grace period is allowed.
- However, recent coronavirus-related relief allows employers to amend their plans to permit the carryover of unused DCAP amounts to plan years ending in 2021 and 2022, or to extend the permissible grace period to plan years over the same period.

DCAP benefit amounts attributable to carryover and extended grace period relief are generally not taxable for 2021 and 2022.

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