

IRS Issues Update for Increase to 2021 Dependent Care FSA Reimbursement Limit

New Guidance Confirms MMA's Earlier Interpretation

The [American Rescue Plan Act of 2021](#) (the "ARPA") became law on March 11, 2021, and it provides economic and other relief related to the COVID-19 pandemic as well as spending for other programs. One of the ARPA's relief provisions for health and welfare benefits is an optional temporary increase to the tax-free dependent care flexible spending account (DCFSA) reimbursable limit from \$5,000 (\$2,500 for married couples filing separate tax returns) to \$10,500 (\$5,250 for married couples filing separate tax returns) for the 2021 calendar year.

We discussed this relief in an earlier [Alert](#), and addressed potential problems and solutions based on our interpretation of existing IRS guidance. The IRS subsequently released [IRS Notice 2021-26](#) on May 10, 2021, confirming our earlier interpretation and providing a few examples.

In this Alert, we will rely on IRS Notice 2021-26 to restate our earlier position and provide our own examples to highlight the potential issues and solutions.

When This is Effective and How to Adopt the Relief

The temporary increase to the annual DCFSA reimbursable limit applies to, "any taxable year beginning after December 31, 2020, and before January 1, 2022." In order to take advantage of the relief, an employer must amend its DCFSA by the end of the plan year implementing the increase and must administer the plan consistently from the intended effective date through the amendment adoption date. The amendment can be retroactive to the beginning of the plan year.

This relief is purely optional, and employers do not have to adopt it. An employer may adopt the relief for a lesser amount instead of the full \$10,500.

The Potential Problem: Taxable Year vs. DCFSA Plan Year

The term "taxable year" means the participant's tax reporting year and not the DCFSA's plan year. An individual's tax reporting year is the calendar year, so the increased DCFSA reimbursement limit applies only to expenses incurred during the 2021 calendar year.

This is problematic for a non-calendar year DCFSA. For now, the reimbursement limit resets to \$5,000 for the 2022 calendar year and amounts reimbursed for expenses incurred during 2022 in excess of \$5,000 are taxable income to the participant. We will highlight this in a pair of examples and discuss potential solutions afterward.

Example 1

ABC Company maintains a calendar year DCFSA and adopts the \$10,500 limit for the 2021 plan year. Josh elects \$10,500 and receives \$10,500 in reimbursements for qualifying dependent care expenses incurred in 2021. ABC Company resets the DCFSA limit to \$5,000 for the 2022 plan year, and Josh elects \$5,000. Josh receives \$5,000 in reimbursements for expenses incurred in 2022.

- *Josh's 2021 DCFSA Taxable Income* – None. Josh's reimbursements did not exceed the \$10,500 reimbursement limit for the 2021 calendar year.
- *Josh's 2022 DCFSA Taxable Income* – None. Josh's reimbursements did not exceed the \$5,000 reimbursement limit for the 2022 calendar year.

Example 2

ABC Company maintains a DCFSA with a plan year beginning on July 1st. The DCFSA limit for the July 1, 2020 – June 30, 2021 plan year was \$5,000. Brooke elected \$5,000 but did not incur any qualifying dependent care expenses during 2020 due to COVID-19. Brooke received \$5,000 in reimbursements for expenses incurred from January 1, 2021 – June 30, 2021.

ABC Company adopts the \$10,500 limit for its July 1, 2021 – June 30, 2022 plan year, and Brooke elects \$10,500. She receives \$6,000 in reimbursements for expenses incurred from July 1, 2021 – December 31, 2021, and \$4,000 for expenses incurred from January 1, 2022 – June 30, 2022.

ABC Company resets the DCFSA limit to \$5,000 for the July 1, 2022 – June 30, 2023 plan year, and Brooke elects \$5,000. She receives \$2,500 in reimbursements for expenses incurred from July 1, 2022 – December 31, 2022, and \$2,500 for expenses incurred from January 1, 2023 – June 30, 2023.

- *Brooke's 2021 DCFSA Taxable Income* – \$500. Brooke's reimbursement for expenses incurred in 2021 is \$11,000, which is \$500 more than the \$10,500 reimbursement limit for the 2021 calendar year.
- *Brooke's 2022 DCFSA Taxable Income* – \$1,500. Brooke's reimbursement for expenses incurred in 2022 is \$6,500, which is \$1,500 more than the \$5,000 reimbursement limit for the 2022 calendar year.

Not an Entirely New Issue: Although usually overlooked, non-calendar year DCFSA's always risk exceeding the applicable calendar year reimbursement limit. Some DCFSA's monitor and limit the total reimbursements between two partial plan years occurring in the calendar year to avoid this. We suspect the IRS specifically addressed this issue in IRS Notice 2021-26, because the increased reimbursement limit for 2021 will make significant excessive reimbursements more likely in 2022.

Potential Solutions

Unlimited Carryovers and Extended Grace Periods

The DCFSA annual limits are subject to the unlimited carryover and extended grace period relief permitted under the Consolidated Appropriations Act, 2021 and [IRS Notice 2021-15](#). A DCFSA *may* permit participants to carry over their entire unused balances from a plan year ending in 2020 to a plan year ending in 2021, and/or from a plan year ending in 2021 to a plan year ending in 2022. In the alternative, a DCFSA *may* allow for a grace period of up to 12 months for plan years ending in 2020 and/or 2021.

Reimbursements made during a calendar year from amounts available due to an unlimited carryover or extended grace period do not count against that calendar year's annual limit.¹

Note: By contrast, DCFSA reimbursements for expenses incurred in the following year from amounts available due to a traditional grace period do count against the following year's annual limit. This is one reason why DCFSA rarely use the 2 ½ month traditional grace period.

Example 1

ABC Company maintains a calendar year DCFSA. ABC Company adopts an unlimited carryover for unused amounts from the 2020 to the 2021 plan year and from the 2021 to the 2022 plan year. Ashley elected \$5,000 for the 2020 plan year but did not incur any qualifying dependent care expenses during 2020 due to COVID-19. The unused \$5,000 carried over to the 2021 plan year.

ABC Company adopts the \$10,500 limit for the 2021 plan year. Ashley elects \$10,500 for the 2021 plan year giving her a total available DCFSA balance of \$15,500. Ashley receives \$12,500 in reimbursements for expenses incurred in 2021, and the unused \$3,000 carries over to the 2022 plan year.

ABC Company resets the DCFSA limit to \$5,000 for the 2022 plan year. Ashley elects \$5,000 giving her a total available DCFSA balance of \$8,000. Ashley receives \$8,000 in reimbursements for expenses incurred in 2022.

- *Ashley's 2021 DCFSA Taxable Income* – None. Although Ashley's \$12,500 in 2021 reimbursements are \$2,000 more than the 2021 \$10,500 reimbursement limit, the excess \$2,000 is solely due to the carryover from 2020 and does not count against the reimbursement limit.
- *Ashley's 2022 DCFSA Taxable Income* – None. Although Ashley's \$8,000 in 2022 reimbursements are \$3,000 more than the 2022 \$5,000 reimbursement limit, the excess \$3,000 is solely due to the carryover from 2021 and does not count against the reimbursement limit.

¹ These amounts also do not count toward the subsequent year for nondiscrimination testing purposes.

Example 2

ABC Company maintains a DCFSA with a plan year beginning on July 1st. ABC Company adopts an unlimited carryover for unused amounts from the July 1, 2020 – June 30, 2021 plan year to the July 1, 2021 – June 30, 2022 plan year.

The DCFSA limit for the July 1, 2020 – June 30, 2021 plan year was \$5,000. Jonathan elected \$5,000 but did not incur any qualifying dependent care expenses during 2020 due to COVID-19. Jonathan received \$2,000 in reimbursements for expenses incurred from January 1, 2021 – June 30, 2021. The unused \$3,000 carried over to the July 1, 2021 – June 30, 2022 plan year.

ABC Company adopts the \$10,500 limit for the July 1, 2021 – June 30, 2022 plan year. Jonathan elects \$10,500 giving him a total available DCFSA balance of \$13,500. Jonathan receives \$8,000 in reimbursements for expenses incurred from July 1, 2021 – December 31, 2021, and \$5,000 for expenses incurred from January 1, 2022 – June 30, 2022. The unused \$500 cannot carry over to the July 1, 2022 – June 30, 2023 plan year and is forfeit.²

ABC Company resets the DCFSA limit to \$5,000 for the July 1, 2022 – June 30, 2023 plan year, and Jonathan elects \$5,000. He receives \$2,500 in reimbursements for expenses incurred from July 1, 2022 – December 31, 2022, and \$2,500 for expenses incurred from January 1, 2023 – June 30, 2023.

- *Jonathan's 2021 DCFSA Taxable Income* – None. Jonathan's \$10,000 in 2021 reimbursements did not exceed the \$10,500 reimbursement limit for the 2021 calendar year. Jonathan does not need to rely on the \$3,000 carryover from the plan year ending June 30, 2021 to reach this result.
- *Jonathan's 2022 DCFSA Taxable Income* – None. Although Jonathan's \$7,500 in 2022 reimbursements are \$2,500 more than the 2022 \$5,000 reimbursement limit, \$3,000 of the reimbursed expenses from January 1, 2022 – June 30, 2022 period are attributable to the carryover from the plan year ending June 30, 2021. Jonathan's 2022 reimbursements for limit calculation purposes are \$4,500.

Another Possible Workaround for Non-Calendar Year DCFSA's

As mentioned earlier, it may be possible to administer a non-calendar year DCFSA to limit the total reimbursements between two partial plan years occurring in same the calendar year to avoid exceeding the annual calendar limit. This is a tricky administrative proposition and even more complicated if the employer changes DCFSA administrators. Employers may wish to discuss this potential workaround with their DCFSA administrator.

Note: Unlike health flexible spending account plans, DCFSA's are not subject to the uniform coverage rule. Reimbursements are already limited to the participant's available DCFSA balance.

² The rules do not permit an unlimited carryover to a DCFSA plan year ending in 2023.

Other Items

Sources of DCFSA Contributions/Reimbursements

The reimbursements can come from any combination of employee pre-tax contributions and employer tax-free contributions/direct reimbursements.

Qualifying Life Event

Adopting the increased limit during the DCFSA plan year triggers a qualifying life event for both existing DCFSA participants to increase elections as well as eligible employees who previously waived coverage. Employers should provide timely notice of the change to employees.

Internal Revenue Code Nondiscrimination Issues

In our experience, most DCFSA fail their annual Internal Revenue Code nondiscrimination requirements. Adopting the increased DCFSA limit for 2021 will probably result in larger corrections for highly compensated DCFSA participants by many employers. Employers may wish to consider restricting the increased limit to rank-and-file employees.

Dependent Care Tax Credit (DCTC)

An employee may be able to claim taxable reimbursements from a DCFSA against the [DCTC](#) when completing his or her personal income tax return and still receive some level of tax savings.

About the Author



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