



## IRS Releases Guidance on Taxation of Dependent Care Benefits Subject to Extended Carryover or Grace Period

MAY 14, 2021

On May 10, 2021, the Internal Revenue Service (IRS) released [Notice 2021-26](#) (the Notice), clarifying the federal income tax implications of recent temporary changes to rules governing dependent care flexible spending accounts (DCFSA) as set forth under the Consolidated Appropriations Act, 2021 (CAA), and the American Rescue Plan Act of 2021 (ARPA). Specifically, the Notice clarified that unused DCFSA benefits subject to an extended carryover or grace period are generally excludable from gross income and are not considered wages of an employee for 2021 and 2022.

### BACKGROUND

Under the CAA, Congress gave plan sponsors offering health care and/or DCFSA enhanced flexibility to help participants avoid forfeiture of unused benefits at the end of a plan year. In particular, plan sponsors can offer a carryover feature whereby participants may elect to “carry over” unused funds from plan years ending in 2020 or 2021 to the end of plan years ending in 2021 and 2022, respectively. Alternatively, plan sponsors can choose to offer participants an extended grace period of 12 months following the end of plan years ending in 2020 or 2021. (See our discussion of the CAA FSA provisions and implementing guidance, [“CAA Benefits Alert: Flexible Spending Account Relief in the 2021 Consolidated Appropriated Act”](#)).

Later, under the ARPA, Congress temporarily increased the maximum exclusion for dependent care benefits from \$5,000 (or \$2,500 for married individuals filing separately) to \$10,500 (or \$5,250 for married individuals filing separately) for any taxable year beginning after December 31, 2020, and before January 1, 2022. Note that the DCFSA exclusion is calculated from the participant’s 2021 taxable year, which is usually the calendar year (as opposed to the plan year, to the extent that they are different). As under the CAA’s extended carryover and grace period rules, plan sponsors have discretion on whether to allow increased contributions.

### TAXATION GUIDANCE

One of the open issues that remained after the CAA and ARPA guidance was released was how the IRS would tax the dependent care funds that were carried over, and which would exceed the previously existing \$5,000 annual

limit. Under the Notice, the IRS clarified that unused dependent care benefits carried into a subsequent tax year pursuant to the CAA remain eligible for exclusion from gross income even if a participant elects to contribute the increased maximum exclusion amount in the subsequent year.

For example, for a DCFSA with a calendar-year plan year:

An employee contributed \$5,000 to a DCFSA in 2020 but did not incur any dependent care expenses that year. The employee carried over the unused \$5,000 to the 2021 plan year and contributed an additional \$10,500 in 2021, as permitted under the ARPA. Assuming that the employee incurred and was reimbursed for \$15,500 in eligible dependent care expenses in 2021, the employee could exclude the entire amount from gross income in 2021.

These rules are considerably more complex in application when looking ahead to taxable year 2022 and, in particular, where a non-calendar plan year is involved. The IRS made clear that the increased limit for 2021 does not apply to reimbursement of expenses *incurred* during 2022. This means that for non-calendar-year plan years spanning 2021 and 2022, only amounts incurred in 2021 qualify for the enhanced income exclusion limit. The standard \$5,000 limitation applies to any amounts carried over both into the plan year ending in 2022 and into the subsequent plan year extending through the remainder of the calendar year (for a potential total exclusion of \$10,000 for calendar year 2022). The Notice includes two useful examples illustrating these principles.

**Winston Takeaway:** *These rules are optional; plan sponsors are not required to adopt carryovers or grace periods or amend plans for the higher DCFSA limit in 2021. Plan sponsors should carefully evaluate this guidance in implementing any optional FSA changes for 2021 and 2022, communicate those changes to participants, and remember to amend plan documents by the end of the year following the year in which changes are made. Note that this guidance does not address implications of adopting the higher \$10,500 limit for 2021 on nondiscrimination testing. Higher limits, along with increased dependent care tax credits under ARPA, may make it more difficult for DCFSA plans to pass nondiscrimination testing, particularly the 55% average benefits test.*

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