

COMPLIANCE BULLETIN

Dependent Care Benefits and the COVID-19 Outbreak

A dependent care assistance program (DCAP) allows employees to pay for qualifying dependent care expenses on a tax-free basis, up to certain limits. With many schools and day care facilities closing due to the COVID-19 outbreak, employees may want to change the amount of their DCAP contributions. Employees may also be concerned about not being able to use all of their DCAP funds this year due to changing needs and availability.

On May 12, 2020, the IRS announced the following **temporary relief** for DCAPs in response to the COVID-19 pandemic:

- **Relaxed Rules for Mid-year Election Changes:** Employers may allow employees to make prospective election changes during calendar year 2020 for DCAPs, regardless of whether the election change satisfies the mid-year election change rules of Internal Revenue Code (Code) Section 125.
- **Extended Period for Incurring Claims:** Employers may allow employees to apply unused DCAP funds remaining at the end of a plan year (or grace period) ending in 2020 to pay or reimburse expenses incurred through Dec. 31, 2020.

In addition, under existing IRS rules, DCAPs may include a **grace period** to allow employees to use any unused funds that remain at the end of the plan year for an additional 2 ½ months. For example, this would allow employees with DCAPs that operate on a calendar year basis to use their 2020 funds for eligible dependent care expenses incurred through March 15, 2021.

Action Steps

To help minimize the impact of the COVID-19 pandemic on employees' dependent care benefits, employers should consider relaxing their rules for mid-year election changes and providing an extended period for incurring DCAP expenses. Employers that make these changes should inform their eligible employees.

Mid-year Election Changes

- Under normal rules, employees cannot make changes to their pre-tax elections for DCAP benefits during the 12-month plan year, with some exceptions.
- Due to the COVID-19 outbreak, the IRS is temporarily relaxing its restrictions on mid-year election changes.
- During 2020, DCAPs may allow employees to prospectively revoke an election, make a new election or decrease or increase an existing election during the plan year.

Forfeiture Rules

- Employees' unused DCAP balances must be forfeited at the end of the coverage period, unless the DCAP has a grace period.
- Due to the COVID-19 outbreak, the IRS extended the period for using DCAP funds for plan years (or grace periods) that end in 2020.



Key Legal Rules

Overview

A DCAP is an employer-sponsored benefit plan that allows employees to pay for certain dependent care expenses on a tax-free basis, up to a specified limit. Most DCAPs are structured so that employees make contributions on a pre-tax basis through a Code Section 125 cafeteria plan. Because of these tax advantages, DCAPs are subject to a number of legal restrictions.

To be eligible for reimbursement by a DCAP, a dependent care expense must be incurred to enable the employee (and the employee's spouse) to be **gainfully employed**. This means that the expense must be incurred to allow the employee (and the employee's spouse) to work or look for work. There is an exception for short, temporary absences from work of two weeks or less, if the employee is required to pay for care during the absence.

Impact of COVID-19 Outbreak

The COVID-19 outbreak may impact employees' DCAP benefits in a variety of ways. Many employees are experiencing changes with day care providers and schools and may want to adjust their pre-tax contribution amounts. Other employees may be concerned that they will forfeit unused funds in their DCAP accounts because their child care expenses or employment status has changed. The IRS has released new guidance that allows employers to design their DCAPs to help minimize the impact of the COVID-19 outbreak on employees' dependent care benefits.

Mid-year Election Changes

DCAPs that include pre-tax contributions must comply with the Code Section 125 restrictions on mid-year election changes. Under Section 125, participant elections must be made before the first day of the plan year and must remain in effect until the beginning of the next plan year. This means that participants typically cannot make changes to their DCAP elections during a plan year. Employers do not have to permit any exceptions to the election irrevocability rule. However, IRS regulations permit employers to design their DCAPs to allow employees to change their elections during the plan year, if certain conditions are met.

On May 12, 2020, the IRS released [Notice 2020-29](#), which provides temporary flexibility for mid-year election changes under a Section 125 cafeteria plan during calendar year 2020. The changes are designed to allow employers to respond to changes in employee needs as a result of the COVID-19 pandemic. During calendar year 2020, employers with DCAPs can allow employees to prospectively make the following changes, regardless of whether they satisfy the Code Section 125 rules for mid-year election changes:

- ☒ Revoke an existing DCAP election;
- ☒ Make a new DCAP election; or
- ☒ Decrease or increase an existing DCAP election.

An employer is not required to permit employees to make these election changes. Rather, an employer can determine the extent to which these changes will be allowed, subject to applicable nondiscrimination rules. If these changes are



permitted, the employer must adopt a plan amendment by **Dec. 31, 2021**, and inform employees of the change. The amendment may be retroactive to Jan. 1, 2020.

Forfeitures

Under Section 125, any unused funds that remain in an employee's DCAP account at the end of the plan year (or coverage period) must be forfeited. As an exception, the IRS allows employers to design their DCAP with an **extended deadline, or grace period, of 2 ½ months after the end of a plan year to use DCAP funds**. Thus, for a plan year ending Dec. 31, the employees would have until March 15 to spend the funds in their DCAP.

In addition, the IRS has recognized that, due to the COVID-19 outbreak, employees may be more likely to have unused funds in their DCAPs. [IRS Notice 2020-29](#) lets employers allow an extended period for incurring dependent care expenses for 2020. Under this guidance, employers may permit employees to apply unused funds remaining in a DCAP at the end of a plan year ending in 2020 (or a grace period ending in 2020) to pay or reimburse expenses incurred through **Dec. 31, 2020**. Employers that implement this extended time period for incurring claims must adopt an amendment for their Section 125 plans by **Dec. 31, 2021**, and inform employees of the change.

Terminated Employees

Under Section 125, individuals whose employment is terminated forfeit any unused balances remaining in their DCAP accounts at the time of the termination. However, the IRS permits DCAPs to incorporate a **spend-down provision** for employees whose participation terminates during a coverage period. At the employer's option, a DCAP may allow terminated participants to use unused amounts in their accounts for dependent care expenses incurred during the remainder of the plan year (or grace period immediately after that plan year, if applicable).

Employer Considerations

To assist employees impacted by the COVID-19 pandemic, employers with DCAPs should consider the following action steps:

- ☑ **Allow employees to change their DCAP elections during 2020**, including revoking existing elections, making new elections and decreasing or increasing existing elections, regardless of whether they satisfy the Code Section 125 rules for mid-year election changes.
- ☑ For DCAPs that have plan years (or grace periods) that end in 2020, provide employees with **an extended deadline of Dec. 31, 2020**, to use any unused funds remaining at the end of that period.
- ☑ **Implement a grace period** that allows employees to use any unused funds that remain at the end of the current plan year for an additional 2 ½ months. For example, this would allow employees with DCAPs that operate on a calendar year basis to use their 2020 funds for eligible dependent care expenses incurred through March 15, 2021.
- ☑ Allow terminated employees to **spend down their accounts** rather than immediately forfeiting the unused amounts.

In addition, employers may wish to remind their employees of the general rule that DCAPs can only reimburse dependent care expenses that are incurred to allow the employee (and the employee's spouse) to work or look for work.