IRS Proposed Regulations Update and Clarify Rules on Dependent Care Assistance Expenses

On May 24, 2006, the Internal Revenue Service (the "Service") issued proposed regulations under Code section 21 of the Internal Revenue Code (the "Code") (Prop. Treas. Reg. §§ 1.21-1 through 1.21-4) that update and clarify the rules relating to reimbursements for dependent care assistance expenses. 71 Fed. Reg. 29847. The proposed rules may be relied upon immediately, although the new rules will not be effective until final regulations are issued. The Service has asked the public to submit comments on the proposed regulations by **August 22, 2006**, giving plan sponsors, plan administrators, and individual taxpayers time to weigh in on the new provisions before the proposed rules are finalized.

In general, Code section 129 allows employers to establish a dependent care assistance program ("DCAP") under which employees may receive tax-free reimbursements for dependent care assistance expenses. Typically, employees are permitted to annually salary reduce their compensation on a pre-tax basis to pay for such dependent care assistance expenses (up to a maximum of $5,000). Code section 129 incorporates many of the rules under Code section 21 (which provides a tax credit for dependent care expenses) by cross reference. For example, the definition of "dependent care assistance expenses" for a DCAP is found in Code section 21. As a result, although the proposed regulations were promulgated under Code section 21, the proposed rules update and clarify the types of expenses that may be reimbursed under a under Code section 129 DCAP. Below is a brief summary of some of the more notable provisions included in the proposed rules.

A. Who Is a Qualifying Individual For Code Section 129 DCAP Purposes?

1. Reflecting Changes in the Law

Benefits under a DCAP are available only with respect to expenses related to "care" for a "qualifying individual." The proposed regulations update the current regulations to reflect changes to the definition of "dependent" made under the Working Families Tax Relief Act of 2004 ("WFTRA") for purposes of determining who is a qualifying individual. For years beginning after December 31, 2004, a qualifying individual means (i) a "qualifying child" (as defined under Code section 152(c)) who has not attained the age of 13, or (ii) a spouse or dependent (e.g., a qualifying child or "qualifying relative" (as defined under Code section 152(d)) who (a) is physically or mentally incapable of care of himself or herself, (b) lives with the employee for more than half of the year, and (c) if care is provided outside the household, spends at least 8 hours per day in the employee's household. Importantly, the proposed regulations do not reflect a change to the definition of qualifying relative made under the Gulf Zone Opportunity Act ("GOZA"). This change eliminates the gross income limitation added to the definition of "qualifying relative" by WFTRA, which Congress inadvertently applied to Code sections 21 and 129.

Groom Observation: The technical correction under GOZA to eliminate the gross income limitation from the definition of a qualifying relative for purposes of Code section 21 means that an adult who is physically or mentally incapable of self-care may be considered a "dependent" under a Code section 129 DCAP without regard to whether such individual has gross income over $3,300 for 2006. Before this technical correction was made, DCAP participants who wanted to use their accounts to pay for care for aging parents or others could not do so if the aging parent or other individual had gross income beyond the maximum threshold. The proposed regulations, however, do not reflect the technical correction made under GOZA. While we assume that the change will be reflected in the final regulations, plan sponsors, plan administrators, and individual taxpayers may want to urge the Service to include *all* of the changes in law made with respect to a qualifying individual.

2. Special Rule for Divorced or Separated Parents

Generally, under Code section 21(e)(5), in order to be considered a qualifying individual of a divorced or separated parent, the child must (i) be under the age of 13 or physically or mentally incapable of self-care, (ii) receive over half of the child's support during the calendar year from one or both of the child's parents, and (iii) be in the custody of one or both parents for more than half of the year. Consistent with a change to Code section 152 under the WFTRA, the proposed regulations take the position that the only parent who may receive tax-free reimbursements under a DCAP is the parent with whom the child lives with for the greater portion of the year (even if the non-custodial parent provides more financial support than the custodial parent).

Groom Observation: This means that, if a child lives with the custodial parent during the school year and the non-custodial parent for two months during the summer, any expenses for care incurred by the non-custodial parent during the two months are not reimbursable. Unfortunately, due to the statutory language in Code section 21(e)(5)(B), which references the "custodial parent" requirement of Code section 152(e)(3), changing this rule such that both parents can receive tax-free reimbursements in this situation would require a change to the statute itself.

B. Dependent Care Assistance Expenses That Are Reimbursable

1. Pre-School-Related Expenses

In general, amounts paid for food, lodging, clothing, or education are not considered dependent care assistance expenses. The proposed regulations confirm, however, that expenses of pre-school or similar programs below the kindergarten level are expenses that may be reimbursed under a DCAP even though education (or the provision of lunch and snacks) may be a significant part of these programs. The proposed rules maintain that expenses flowing from programs at the kindergarten level or higher grades are primarily for education and not reimbursable, but the new rules clarify that expenses for before- or after-school care of a child in kindergarten or a higher grade may be reimbursed.

Groom Observation: The Service does not provide any formal guidance on why pre-school expenses are distinguishable from kindergarten expenses, and current regulations provide that expenses in the "first" or "higher grades" are not reimbursable expenses. Although the Service has informally concluded that amounts paid for kindergarten are primarily for education, plan sponsors, plan administrators, and individual taxpayers may want to comment that expenses of kindergarten are similar to expenses of pre-school and the threshold for determining whether expenses are for education or other purposes should begin at grade 1. In addition, commentators may want to note that care provided before or after school is synonymous with care provided in kindergarten, and therefore, expenses of kindergarten should be reimbursable even if education is a significant part of the care.

2. Day Camps

The proposed regulations clarify that although expenses for over-night camps may not be reimbursed, expenses incurred for day camps or similar programs may be reimbursed even though the camp specializes in a particular activity (e.g., soccer or computer day camp).

Groom Observation: The prohibition on reimbursing over-night camp expenses is a statutory prohibition. However, plan sponsors, plan administrators, and individual taxpayers may want to comment that the Service should construe this statutory prohibition to allow parents to allocate expenses between daytime and nighttime activities, which would be consistent with the statute and the proposed regulations.

3. Transportation Expenses

Expenses incurred for transportation are generally not expenses for care, and therefore, may not be reimbursed under a DCAP. The proposed regulations provide, however, that expenses related to transportation to and from the place of care (e.g., a day camp or other after-school programs off school premises) furnished by a care provider may be reimbursed.

Groom Observation: The Service does not provide any basis as to why transportation provided by a care provider versus transportation provided by a parent or spouse are reimbursable expenses. Often, a care provider does not offer transportation to and from a parent or spouse's household to the place of care. As a result, taxpayers that are required to transport their dependent to the place of care on their own should not be penalized in these instances. Thus, plan sponsors, plan administrators, and individual taxpayers may want to comment that there should be no difference between transportation provided by the parent or spouse versus transportation provided by the care provider, especially in situations where the care provider does not offer transportation to the place of care.

4. Employment-Related Expenses

The proposed regulations essentially codify prior IRS guidance providing that expenses incurred for room and board of a care provider may be reimbursed under a DCAP. In addition, the proposed rules provide that employment taxes (e.g., FICA and FUTA) for compensation paid to a care provider and any indirect expenses such as application fees, agency fees, and deposits made to obtain care are reimbursable expenses under a DCAP. The proposed rules make clear, however, that fees paid to obtain care are only reimbursable in the tax year in which the care is actually provided, and forfeited deposits are not reimbursable.

Groom Observation: It is unclear what expenses would qualify for "room and board" expenses under the proposed regulations. As a result, plan sponsors, plan administrators, and individual taxpayers may want to urge the Service to illustrate what expenses may be reimbursed in a number of examples. In addition, plan administrators may want to comment that tracking the tax year in which application or agency fees are paid and the tax year in which care is actually provided may be administratively burdensome, and suggest an alternative.

C. Expenses Incurred During Temporary Absences and Part-Time Work May Still Be Reimbursed

1. Short or Temporary Absences

In addition to expenses incurred for care, dependent care assistance expenses incurred so that a parent or spouse can work or look for work (i.e., be "gainfully employed") may generally be reimbursed under a DCAP. However, if a parent or spouse is absent from work for only a short amount of time, dependent care expenses incurred during the absence are generally not reimbursable. The proposed regulations clarify that "short" or "temporary" absences for illness or vacation will not preclude the employee from being reimbursed for dependent care assistance expenses if the employee is required to pay for these expenses on a weekly or longer basis. Whether an "absence" is short or temporary depends on facts and circumstances. The proposed rules set forth examples illustrating periods that would and would not be acceptable. For example, a 4-month absence is *not* short or temporary, whereas 2 days off *is* short and temporary.

Groom Observation: The Service specifically requested comments on the appropriate period for constituting a "short" or "temporary" absence. As a result, plan sponsors, plan administrators, and individual taxpayers have an opportunity to shape a standard. For example, while the proposed regulations indicate that the Service believes that 4 months is not short or temporary, commentators may want to note that a 3 month absence is reasonable. In addition, commentators may want to suggest that the Service establish standards for illnesses or absences to provide care to a dependent versus, for example, absences due to vacation.

2. Part-Time Employees

The proposed regulations provide that parents or spouses that work part-time (at least 1 hour per day) must allocate expenses between days worked and not worked. However, parents or spouses who work part-time but are required to pay for dependent care expenses on a weekly or longer basis are not required to allocate expenses between days worked and not worked. For example, if an employee only works 3 days a week, but is required to pay expenses for the entire 5-day work week, all of these expenses are reimbursable. However, if the employee is only charged for the 3 days of care, only the expenses for the 3 days are reimbursable.

Groom Observation: While the allocation of reimbursable expenses between days worked and not worked by a part-time employee appears reasonable, plan administrators may want to comment that determining whether dependent care expenses are being paid daily, weekly, or on a longer basis may be administratively burdensome and suggest an alternative standard.

D. Conclusion

The proposed regulations, while not ground-breaking, essentially codify the Service's informal and formal position on certain issues relating to dependent care assistance expenses. In general, the proposed regulations should be welcomed by plan sponsors, plan administrators, and individuals due to the clarifications made. Because the new rules are in proposed form, plan sponsors, plan administrators, and individuals have an opportunity to further shape these provisions in way that makes sense from a participant and administrative perspective.

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Please contact Chris Keller or Chris Condeluci at (202) 857-0620 with any questions on DCAPs generally, or for assisting with submitting comments.

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