

Dependent Care FSAs Have Issues Also

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Probably 90 percent or more of flexible spending account (FSA) attention is on health FSAs. By comparison, dependent care FSAs would seem to be trouble-free and easy to administer. Correct?

Incorrect.

Dependent care FSAs have issues, too. An unwary employer can walk right into one of several different traps. In this article, we will explore six issues related to dependent care FSAs, also known as dependent care assistance programs under Code Section 129. (For more on dependent coverage, see ¶350 of the *Handbook*.)

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Midyear Changes to an Election

Because dependent care FSAs are offered on a tax-free basis through a cafeteria plan, participants are restricted from changing their elections during the plan year. There are three basic reasons for changing a dependent care FSA election:

Change in Status

This could include any of the following:

- marriage;
- divorce;
- adding a child through birth or adoption;
- changing jobs;
- change in residence of a parent;
- change in work schedule; or
- a leave of absence.

The election change must be consistent with the event, however. For example, adopting a child who is under age 13 (the age at which dependent care FSA benefits are no longer available) would NOT justify a decrease in the annual election. It would justify an increase in the election amount to the maximum of \$5,000, \$2,500 if married filing separately.

Family and Medical Leave Act

Employees do not have an automatic right to change elections. Instead, they may do so to the same extent as taking non-FMLA leave. This right should be specified in the plan's summary plan description (SPD, see ¶821) and the employer's FMLA policy.

Change in cost and coverage

These events typically do NOT allow an election change for health FSAs, but do trigger election change rights for the dependent care FSA. It is interesting to note that unlike most cost/coverage changes, it is the employee (not the employer or insurance carrier) who initiates the event. A cost/coverage change would exist any time there is a change in day care providers.

The Gainful Employment Rule

This is an essential requirement to reimburse a dependent care expense. The expense must enable both the employee and the employee's spouse to be "gainfully employed." For example, a day care expense incurred to cover expenses a parent incurs for care rendered while

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he or she is working on a Saturday would not be reimbursable if the other spouse was not working that day, even if the spouse had already made other plans. On the other hand, when one spouse works a night shift and has to sleep during the day, ordinary day care would be reimbursable.

An exception exists for short, temporary absences that are no longer than two weeks. An example might include an employee's vacation when the day care provider continues to charge for day care even though the employee is absent from work and the child is absent from day care.

The gainful employment rule puts additional burdens on part-time employees, who must allocate their expenses based on their days worked. If an employee works one hour during a day, that counts as a workday. Thus, an individual who works three days a week can be reimbursed for 60 percent of the full week's day care expense, if the provider is willing to accept a reduced fee for a partial week. If there is one flat fee, 100 percent of the weekly fee is reimbursable.

Gainful employment includes looking for work and enrollment as a full-time student. Also, a spouse who is incapable of self-care is exempted from the gainful employment requirement. Self-employment counts, unless the spouse has no earned income for the year, in which case all of the dependent care benefits are taxable. Volunteer work is not gainful employment.

Babysitters

Two advantages of babysitters are:

- 1) the fact that care typically occurs at home; and
- 2) the cost is usually less than a registered facility.

Often, babysitters are related to the employee, and that is where troubles can start. Grandparents, aunts and uncles are almost always OK. These four categories are on the "do not fly" list with the IRS:

- the employee's child, step-child, or foster child if the child is under age 19 at the end of the year;
- the employee's or employee's spouse's qualifying child under Code Section 152;
- the employee's spouse; and
- the parent of the child.

Incidental Fees and Deposits

When an employee signs up a child in advance at a day care facility, the policies and fees can be confusing. These can include application fees, agency fees, late pick-up fees and deposits. These fees are reimbursable if the employee must pay them in order for the child to receive care.

Example. An application fee typically is required so the agency can process the paperwork. This would be reimbursable on the first day that care is provided. Therefore, if the family decides to place the child at the facility and forfeits the application fee, the fee is not reimbursable. The same holds true for a deposit.

Let's consider another common situation. A facility closes at 6:30 p.m. and charges \$10 for every 15 minutes that a parent is late in picking up the child. Because this fee reimburses care that was provided, the fee would be reimbursable.

Treatment of Dependent Care FSA Administrative Costs

Most employers outsource FSA administration. Because dependent care FSA participation rates are commonly much lower than those for health FSAs, an employer might want to have dependent care FSA participants pay for the administrative costs. The cafeteria plan regulations allow pre-tax salary reductions to pay for "reasonable cafeteria plan administrative fees" so this seems like a permissible approach. Once an employer has communicated this through the SPD, there is a follow-up question: what does the employer do with the \$5,000 annual cap on reimbursements?

See Dependent Care, p. 4

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IRS SETS HSA, HDHP LIMITS FOR 2012

The IRS has issued the health savings account (HSA) and high-deductible health plan (HDHP) limits for calendar year 2012. The HSA annual limits and the annual out-of-pocket expenses for HDHPs are higher than those the IRS set for 2011; the HDHP annual deductibles for 2012 are the same as those the IRS set for 2011. The IRS made the announcement in Revenue Procedure 2011-32. (See ¶292 of the *Handbook* for more on HSAs.)

The 2012 rates will be as follows:

HSAs

- annual limit of \$3,100 on deductions for an individual with self-only coverage under an HDHP

- annual limit of \$6,250 on deductions for an individual with family coverage under an HDHP

HDHPs

HDHP definition based on the following:

- annual deductible of \$1,200 for self-only coverage
- annual deductible of \$2,400 for family coverage
- annual out-of-pocket expenses of \$6,050 for self-only coverage
- annual out-of-pocket expenses of \$12,100 for family coverage

See *CDHC*, p. 5

Dependent Care (continued from p. 3)

Two possible answers exist. For both examples, let's assume an FSA costs \$6 per participant, per month to administer, \$3 of which is allocated to the dependent care FSA. That's \$36 per participant, per year.

Example. Simply deduct \$3 per month from the dependent care FSA balance. At the end of the year, only \$4,964 would be available for reimbursement because the \$36 in administrative fees would be viewed as a dependent care expense subject to the \$5,000 cap. The employer would include the \$36 fee in Box 10 of Form W-2, and the employee would include it on Form 2441.

Example. Simply conclude that the \$36 was a cafeteria plan administrative fee and allow salary reductions of up to \$5,036. At the end of the year, the full \$5,000 would be available for reimbursement (if a participant had a \$5,036 salary reduction election) because the \$36 in administrative fees would be viewed as a cafeteria plan expense, not subject to the \$5,000 cap. The employer would exclude the \$36 fee in Box 10 of Form W-2, and the employee would not include it on Form 2441.

IRS has not ruled on which approach (or even both approaches) would be permissible.

Non-Calendar Plan Years

Because the \$5,000 annual cap is based on a calendar year, it is strongly recommended that dependent care FSAs also adopt a calendar plan year, even if the health

FSA and other cafeteria plan benefits have a differently measured year.

Here's why.

Administrators need to consistently monitor the annual cap on a calendar year basis as well as a plan year basis. Excess reimbursements are taxable. Once expenses exceed the cap, reimbursements must end, even though salary reductions will continue.

Example. Assume a dependent care FSA with a July-June plan year. A participant may incur enough expenses in the first six months of the calendar year to reach the cap. Then, when the dependent care FSA renews on July 1, the participant must wait until the next January before incurring expenses that can be reimbursed.

Form W-2 reporting is a challenge. The IRS allows an employer to report a reasonable estimate of the dependent care FSA benefit in Box 10, but for a non-calendar plan, this amount will usually not match the expenses actually incurred by the participant.

Nondiscrimination testing is also a little more difficult. The definition of "highly compensated employee" is based on compensation received in the prior plan year. An employer cannot simply look at the prior year's W-2.

Dependent care FSAs are a simple way to pay for dependent care expenses on a pre-tax basis. But issues arise sometimes, making dependent care FSA administration is not-so-simple task. 🏠

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