

# COMPLIANCE BULLETIN

## Dependent Care Benefits and COVID-19 Outbreak

A dependent care assistance program (DCAP) allows employees to pay for qualifying dependent care expenses, such as day 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. Also, employees may be concerned about not being able to use all of their DCAP funds this year due to changing child care needs and availability.

Although the IRS has not issued any specific relief or guidance for DCAP benefits due to the COVID-19 outbreak, existing rules may help employees impacted by the outbreak. For example, under existing rules, DCAPs can be designed to:

- Allow employees to change their pre-tax elections when there is a change in employment status or if there is a change in cost or coverage of dependent care services.
- 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.
- Allow terminated employees to spend down their accounts rather than immediately forfeiting the unused amounts.

### Action Steps

To assist employees impacted by the COVID-19 pandemic, employers should review their DCAP's rules for mid-year election changes, grace periods and spend-down provisions for terminated employees.

## Mid-year Election Changes

- As a general rule, employees cannot make changes to their pre-tax elections for DCAP benefits during the 12-month plan year.
- As an exception, DCAPs can be designed to allow mid-year election changes when certain events occur.
- These events include a change in employment status and a change in cost or coverage of dependent care services.

## Forfeiture Rules

- Employees' unused DCAP balances must be forfeited at the end of the coverage period, unless the DCAP has a grace period.
- Terminated employees must forfeit their DCAP balance, unless the DCAP has a spend-down provision.

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## DCAP – Key Legal Rules

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 an Internal Revenue Code (Code) Section 125 cafeteria plan. Because of these tax advantages, DCAPs are subject to a number of legal restrictions.

### 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 need to adjust their pre-tax contribution amounts. Other employees may be concerned that they will forfeit unused amounts in the DCAP account because their child care expenses or employment status has changed. Employers with DCAPs should be familiar with legal restrictions that may impact employees during the COVID-19 outbreak. Employers may design their DCAPs to help minimize the impact of the COVID-19 outbreak on employees' DCAP 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. DCAPs may be designed to allow employees to change their elections when the following events occur, provided that the employee's requested change is consistent with the event:

Event	Description
<b>Change in Status Event</b>	A change in the employee's number of dependents, a change in employment status of the employee or spouse, a change in the place of residence of the employee, spouse or dependent or the employee's spouse or a dependent child ceasing to satisfy dependent eligibility requirements may allow an employee to change his or her election during a plan year. This may occur, for example, if an employee changes work schedules from full time to part time, which reduces the hours of child care needed and the amount of dependent care expenses.
<b>Changes in Cost or Coverage</b>	Changes in cost and coverage for dependent care services may allow an employee to change his or her election during the plan year. This may occur when a child care provider is no longer providing care (for example, a daycare closes or a summer camp cancels), when an employee switches from a paid provider to free care (for example, a relative or neighbor), when an employee no longer needs child care or when an employee needs additional child care due to a school closure.

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## Family Medical Leave Act (FMLA) Leave

Employees who take an FMLA leave are entitled to revoke an election of non-health benefits (such as DCAP benefits) to the same extent as employees taking a non-FMLA leave are permitted to revoke elections of non-health benefits.

### Forfeitures

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, 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 taking the following steps:

- ☑ Review their DCAP plan documents to confirm that they **permit mid-year election changes** for changes in employment status, changes in cost or coverage and FMLA leave. Depending on the specific facts involved, many of the changes that employees are experiencing in connection with the COVID-19 outbreak (for example, child's daycare is closed) are exceptions that allow employees to change their DCAP elections.
- ☑ **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.

### Eligible Expense – Gainful Employment

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.