American Rescue Plan Act

The American Rescue Plan Act of 2021 ("American Rescue Plan" or "ARPA") was approved by the House and Senate, and President Biden signed this bill into law on Thursday, March 11, 2021. The American Rescue Plan is the latest COVID-19 relief bill and contains many provisions aimed to help Americans in a variety of ways. Included in this bill is one specific provision related to reimbursement accounts.

The American Rescue Plan Act: Dependent Care Tax Exclusion Increase

As part of the American Rescue Plan Act (ARPA), a provision was included to temporarily increase the Dependent Care tax exclusion limit from $5,000 to $10,500 for any taxable year beginning after December 31, 2020 and before January 1, 2022.

New Information: IRS Notice 2021-26 – Taxation of Dependent Care Benefits

On May 5, 2021 the IRS released Notice 2021-26 titled Taxation of Dependent Care Benefits Available Pursuant to an Extended Claims Period or Carryover. This notice clarifies that dependent care benefits made available through a carryover or grace period extension as a result of the CAA will remain excludable from income if the benefits would have been excluded from income if used during the preceding taxable year, even if the amount reimbursed exceeds $10,500 during the 2021 taxable year or $5,000 during the 2022 taxable year. The impact of this guidance on individuals will vary depending on your plan design. As a result, Sentinel is recommending a different course of action depending on your plan year. Please see below for an overview of the application of this guidance for calendar year plans vs. non-calendar year plans.

Calendar Year Plans

Application of the IRS guidance is fairly straightforward for plans that operate on a calendar year and Sentinel recommends allowing an increased limit of $10,500.00 for Dependent Care contributions in 2021. Please note, the limit for 2022 is set to return to $5,000. The IRS provided the following example regarding taxable treatment of benefits for a calendar year plan:

> **EXAMPLE 1**: An employee is covered by a calendar year § 125 cafeteria plan that offers a DCAP benefit. The employee elects no DCAP benefits for the 2019 plan year. The employee elects to contribute $5,000 for DCAP benefits for the 2020 plan year but incurs no dependent care expenses during the plan year. Pursuant to § 214 of the Act, the § 125 cafeteria plan allows the employee to carry over the unused $5,000 of DCAP benefits to the 2021 plan year. The employee elects to contribute $10,500 for DCAP benefits for the 2021 plan year. The employee incurs $15,500 in dependent care expenses in 2021 and is reimbursed $15,500 by the DCAP. The $15,500 is excluded from the employee's gross income and wages because $10,500 is excluded as 2021 benefits and the remaining $5,000 is attributable to a carryover permitted under § 214 of the Act.

Non-Calendar Year Plans

Application of the IRS guidance for plans that operate on a non-calendar year is more complex. Employees may face unintended tax consequences based on when eligible services occur. As a result, Sentinel does <u>not</u> recommend allowing an increased limit of $10,500 for Dependent Care contributions if your plan operates on a non-calendar year. The IRS provided the following examples regarding taxable treatment of benefits for a non-calendar year plan:

> **EXAMPLE 2**: An employee is covered by a non-calendar year § 125 cafeteria plan that offers a DCAP benefit. The § 125 cafeteria plan has a July 1 to June 30 plan year. The employee elects no DCAP benefits for the plan year beginning July 1, 2019. For the plan year beginning July 1, 2020, the employee elects to contribute $5,000 for DCAP benefits, but the employee incurs no dependent care expenses during the plan year. Pursuant to § 214 of the Act, the § 125 cafeteria plan

allows the employee to carry over the unused $5,000 of DCAP benefits to the plan year beginning July 1, 2021.

Taxable Year 2021 – Facts and Conclusion. Pursuant to § 9632 of the ARP, the employee elects to contribute $10,500 for DCAP benefits for the plan year beginning July 1, 2021. The employee has $15,500 available for dependent care expenses for the plan year beginning July 1, 2021. The employee incurs no dependent care expenses during the period from July 1, 2021, to December 31, 2021, and has $15,500 of DCAP benefits available as of January 1, 2022. For the taxable year 2021, the employee did not receive any DCAP benefits because no dependent care expenses eligible for reimbursement under the DCAP were incurred in 2021.

Taxable Year 2022 – Facts and Conclusion. For the taxable year 2022, the exclusion for DCAP benefits under § 129 of the Code is $5,000. The employee incurs $7,000 in dependent care expenses during the period from January 1, 2022, through June 30, 2022, and is reimbursed $7,000 by the DCAP. The § 125 cafeteria plan adopts a 2½ month grace period that is added to the end of the plan year beginning July 1, 2021, which allows the employee to use the unused $8,500 of DCAP benefits until September 15, 2022. The employee elects to contribute $5,000 for DCAP benefits for the plan year beginning July 1, 2022. The employee incurs $8,500 in dependent care expenses during the period from July 1, 2022, through September 15, 2022, and incurs $2,500 in dependent care expenses during the period from September 15, 2022, through December 31, 2022. The employee is reimbursed $11,000 by the DCAP ($8,500 plus $2,500). The employee therefore receives $18,000 ($7,000 plus $11,000) in reimbursements of dependent care expenses during the 2022 taxable year. Of the $18,000 received in calendar year 2022, $10,000 is excluded from the employee's gross income and wages because $5,000 is excluded under the exclusion for DCAP benefits under § 129 of the Code for the taxable year 2022, and $5,000 of the $7,000 received from January 1, 2022, to June 30, 2022, is excluded because it is attributable to carryovers permitted under § 214 of the Act that would have been excluded from gross income if used in the preceding taxable year (that is, attributable to carryovers to plan years ending before 2023). The remaining $8,000 is included in the employee's gross income and wages because it is not attributable to carryovers permitted under § 214 of the Act.

EXAMPLE 3: An employee is covered by a non-calendar year § 125 cafeteria plan that offers a DCAP benefit. The § 125 cafeteria plan has a July 1 to June 30 plan year. The employee elects no DCAP benefits for the plan year beginning July 1, 2020, and there are no unused amounts from prior plan years available.

Taxable Year 2021 – Facts and Conclusion. Pursuant to § 9632 of the ARP, the employee elects to contribute $10,500 for DCAP benefits for the plan year beginning July 1, 2021. The employee incurs $5,000 in dependent care expenses during the period from July 1, 2021, to December 31, 2021, and receives $5,000 in reimbursements during 2021. The $5,000 is excluded from the employee's gross income and wages pursuant to § 129 of the Code. The employee has $5,500 of DCAP benefits available as of January 1, 2022.

Taxable Year 2022 – Facts and Conclusion. For the taxable year 2022, the exclusion for DCAP benefits under § 129 of the Code is $5,000. The employee incurs $5,500 in dependent care expenses during the period from January 1, 2022, through June 30, 2022, and is reimbursed $5,500 by the DCAP. The employee elects to contribute $5,000 for DCAP benefits for the plan year beginning July 1, 2022. The employee incurs $2,500 in dependent care expenses during the period from July 1, 2022, to December 31, 2022, and is reimbursed $2,500 by the DCAP. The employee receives a total of $8,000 in reimbursements for DCAP benefits during 2022. Of the $8,000 received in the 2022 taxable year, $5,000 is excluded from the employee's gross income and wages under the exclusion for DCAP benefits under § 129 of the Code. The remaining $3,000 received by the employee is included in the employee's gross income and wages.

Electing Plan Changes

If you wish to allow employees to contribute up to $10,500 for the plan year beginning in 2021, you will need to opt-in to this provision using this electronic form: https://lfforms.sentinelgroup.com/Forms/AmericanRescuePlan. Once submitted, your Sentinel FSA Account Manager will reach out to you to address any questions and to confirm receipt.

Once your submission is received and the details are confirmed, Sentinel will make the appropriate updates in our system to allow for contributions up to $10,500 for the plan year beginning in 2021. Additionally, a Plan Document Amendment will be required to formally adopt the change into the plan. This amendment will be issued later on in 2021. If you previously adopted changes under the Consolidated Appropriations Act of 2021, the amendments will be combined and your organization will be charged one plan amendment fee of $175 (or, if different, the amount stated in your Services Agreement). If you have not previously adopted changes under the Consolidated Appropriations Act of 2021, the cost of the amendment to address the DCAP increase elected above will be $175 (or, if different, the amount stated in your Services Agreement).