



# Plan Design

## Dependent Care Assistance Programs (DCAPs)

In August 2007, the Internal Revenue Service finalized regulations governing tax-favored treatment of dependent care expenses. The regulations affect Dependent Care Assistance Programs (DCAPs) and the dependent care tax credit under IRC Section 21. The regulations became effective August 14, 2007 for taxable years ending after that date.

This Plan Design provides a brief overview of DCAPs, including a summary of the provisions within the IRS regulations that affect DCAPs.

### **What is a Dependent Care Assistance Program (DCAP)?**

A DCAP is an employer-sponsored program. It establishes an account from which an employee may seek reimbursement for eligible dependent care expenses. In most cases, a DCAP account is funded by employees with pre-tax dollars through payroll deductions.

A DCAP may be offered within a cafeteria plan or as a separate plan. Where a DCAP is offered within a cafeteria plan, it is subject to the same rules which govern cafeteria plans.

### **What dependent care expenses are eligible for reimbursement?**

A dependent care expense is eligible for reimbursement from a DCAP if it is an employment-related expense. An employment-related expense must be:

- Primarily for “household services” or for the “care of a qualifying individual,” and
- Enable the taxpayer to be “gainfully employed.”

### **What “household services” are eligible for reimbursement?**

Household services that are performed in and about the taxpayer’s home, ordinary and usual services necessary to the maintenance of the household, and attributable to the care of the qualifying individual, are reimbursable.

The regulations clarify that housekeeper services provided to the qualifying individual are eligible for reimbursement. However, services provided by chauffeurs, bartenders, or gardeners are not eligible.

### **What expenses for the “care of a qualifying individual” are eligible for reimbursement?**

Expenses for the care of a qualifying individual are reimbursable where the primary function is to assure the individual’s well-being and protection. Expenses for food, lodging, clothing or education are not eligible, unless these other goods and services are incidental to and inseparably a part of the care.

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If an expense is partly for care of the qualifying individual and not merely incidental, the regulations clarify that an allocation can be made to allow the employee to be reimbursed for the portion of that expense that is attributable to caring for the qualifying individual. The regulations include an example of an allocation where the cost of preschool child-care service includes meals for the students. In this example, the cost of meals was considered incidental to and inseparably part of the care. Therefore, the employee may seek reimbursement for the full cost of the preschool program without allocating any portion of the expense to meals.

Care of a qualifying individual may include household services or services outside the taxpayer's home. For example, nursery school and daycare may be eligible expenses.

The regulations provide the following guidance related to employment-related expenses for the care of a qualifying individual:

- Expenses for a nursery school, preschool, or similar program below the level of kindergarten are eligible.
- Expenses for kindergarten or higher grade levels are not eligible.
- Expenses for before- or after- school care of a child in kindergarten or a higher grade are eligible.
- Expenses for overnight camps are not eligible.
- Day camp expenses, including specialty camps such as sports or computer, are eligible.
- Expenses for transportation provided by the dependent care provider to or from the place of care are eligible. The cost of transportation provided by anyone else is not eligible.
- Employment taxes paid to a caregiver are eligible.
- Expenses related to providing room and board to a caregiver may be eligible.
- Indirect expenses such as application fees, deposits, or agency fees paid to obtain dependent care services are eligible.
- Payments to either the taxpayer's spouse or to a parent of the taxpayer's child who is not the taxpayer's spouse are not eligible for reimbursement.

In order for an expense to be eligible for reimbursement, it must be an employment-related expense, primarily for household services or for the care of a qualifying individual, and enable the taxpayer to be gainfully employed.

### Who is a "qualifying individual"?

The regulations define a qualifying individual as:

- The taxpayer's dependent who is under the age of 13, or
- The taxpayer's dependent or spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than one-half of the taxable year.

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According to the regulations, an individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, he or she is incapable of caring for the individual's hygiene or nutritional needs, or requires full-time attention of another person for the individual's own safety or the safety of others. The individual's inability to engage in any substantial gainful activity or perform the normal household chores or care for minor children does not in itself make the individual physically or mentally incapable of self-care.

Whether someone is a qualifying individual must be calculated on a daily basis. For example, upon a dependent's 13<sup>th</sup> birthday, the employee may no longer seek reimbursement for dependent care expenses incurred after his or her dependent's birthday. Employees should take into consideration the daily calculation requirement when making their annual elections.

### What constitutes "gainful employment"?

Gainful employment may consist of service within or outside the taxpayer's home, including self-employment, and time spent actively seeking gainful employment. Time spent actively seeking gainful employment includes time spent as a full-time student in an educational organization. Where the purpose of the expense is to enable the taxpayer and the taxpayer's spouse to be gainfully employed depends upon the facts and circumstances of the particular case. Whether an expense was related to gainful employment is calculated on a daily basis.

If an employee is married, the employee's spouse must be employed, including self-employed, actively seeking gainful employment, or a full-time student in an educational organization during the time that the employee seeks reimbursement of dependent care expenses.

The regulations provide the following guidance related to employment-related expenses that enable the taxpayer to be gainfully employed:

- Work as a volunteer or for nominal consideration is not gainful employment.
- Where dependent care expenses are paid on a weekly, monthly, or annual basis, the taxpayer is not required to allocate expenses incurred during short, temporary absences from work, such as for minor illness or vacation.
- Part-time employees may only seek reimbursement for dependent care expenses incurred on the day in which the employee works. If the employee works at least one hour, the employee is permitted to deduct dependent care expenses for that day.
- If a dependent care center requires payment for periods of no less than one week, but a part-time employee only works four days each week, the employee may seek reimbursement for daycare expenses equal to the weekly rate.
- Enrollment within night school constitutes full-time enrollment in an educational organization.



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### **Is there a limit on how much money may be contributed to a DCAP?**

Yes. IRC Section 129 allows a married employee that files a joint tax return to place up to \$5,000 per calendar year in a DCAP. A married employee that files separate returns may only place up to \$2,500 per calendar year in a DCAP. Expenses may only be reimbursed after the dependent care services have been performed. For example, if a dependent care provider requires payment at the beginning of the week, the employee may not seek reimbursement until the end of the week.

Under the dependent care tax credit of IRC Section 21, an employee may also be eligible to deduct eligible dependent care expenses on his or her tax return which were not reimbursed through a DCAP.

Many employers sponsor Dependent Care Assistance Programs in an effort to assist employees with the cost of dependent care expenses. A DCAP provides employees with the ability to use pre-tax dollars to pay dependent care expenses. Fickewirth and Associates welcomes the opportunity to assist your organization in establishing a Dependent Care Assistance Program or to answer questions relating to the regulations and their impact upon your existing DCAP.

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