

## IRS Clarifies Taxability of Dependent Care Benefits Provided Pursuant to a Carryover or Extended Grace Period

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The IRS recently issued Notice 2021-26 (the "**Notice**"), which addresses certain questions that were not specifically answered in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (enacted as part of the Consolidated Appropriations Act, 2021), and subsequent IRS guidance (collectively, the "**CAA Guidance**"). The CAA Guidance addressed the taxability of dependent care benefits provided under a dependent care assistance program (**DCAP**) when a carryover or extended grace period is applied.

As discussed in our prior blog post [here](#), the CAA Guidance permits employers to adopt (i) a carryover of unused DCAP funds from taxable years 2020 to 2021 and 2021 to 2022 (**CAA Carryover**) or (ii) an extended grace period for incurring DCAP claims for plan years ending in 2020 and 2021 (**CAA Extended Grace Period**). The CAA Guidance confirms that any unused DCAP amounts carried over from one year (**Prior Year**) to, or available in, the subsequent year (**Subsequent Year**) pursuant to a CAA Carryover or CAA Extended Grace Period *are not counted* toward the annual DCAP contribution dollar limit for the Subsequent Year (the "**Contribution Limit**"). However, the CAA Guidance did not specifically address the *taxability* of such unused amounts.

The Notice provides helpful guidance on that point, clarifying that unused amounts that would have been excluded from the employee's taxable income if used during the Prior Year remain eligible for the exclusion from the employee's taxable income. The Notice further confirms that such amounts are disregarded for purposes of applying the Contribution Limit when they are carried over to, or available in, a Subsequent Year based on a CAA Carryover or CAA Extended Grace Period.

In addition, the Notice includes several examples that illustrate possible tax consequences that could apply in situations involving a CAA Carryover and CAA Extended Grace Period, such as where employees elect contributions under a non-calendar year DCAP in an amount equal to the increased Contribution Limit for the 2021 plan year, as permitted by the America Rescue Plan Act of 2021 (the "**ARPA**") (*i.e.*, \$10,500 or \$5,250 for a married individual filing separately). See our blog post regarding the increased Contribution Limit under the ARPA [here](#).

The Notice is available [here](#).