



TaxNewsFlash

United States



No. 2021-207
May 10, 2021

Notice 2021-26: Treatment of dependent care assistance programs clarified for 2021 and 2022 (COVID-19)

The IRS today released an advance version of Notice 2021-26 as guidance on the tax treatment of dependent care benefits available in tax years ending in 2021 and 2022.

Notice 2021-26 [PDF 129 KB] clarifies that if eligible dependent care benefits would have been excluded from income if used during the preceding tax year (that is, during the tax year ending in 2020 or 2021), these benefits remain excludable from gross income and are not wages to the employee for the tax years ending in 2021 and 2022.

Notice 2021-26 also clarifies that these benefits will not be taken into account for purposes of the application of the limits under section 129 to other dependent care benefits available for the tax years ending in 2021 and 2022.

Background

Under dependent care programs, an employer allows its employees to set aside a certain amount of pre-tax wages to pay for dependent care expenses, and the employee's expenses for care of their dependents are then reimbursed from the dependent care assistance program.

Carryovers of unused dependent care assistance program amounts generally are not permitted (although a 2½ month grace period is allowed).

Individuals may have not been able to use the money they set aside in their dependent care assistance programs in 2020 and 2021 because of the effects of the coronavirus (COVID-19) pandemic. However, the "Taxpayer Certainty and Disaster Tax Relief Act of 2020" (enacted as part of the "Consolidated Appropriations Act, 2021" (Pub. L. No. 116-260) enacted December 27, 2020), allows employers to amend their plans to permit a carryover of unused dependent care assistance program amounts to plan years ending in 2021 and 2022, or to extend the period for incurring claims to plan years over the same period.

The IRS in February 2021 issued Notice 2021-15 to provide temporary special rules for health flexible spending arrangements (health FSAs) and dependent care assistance programs under section 125 cafeteria plans. Notice 2021-15 provides that if an employer adopted a carryover or extended period for incurring dependent care-related claims, the annual limits for dependent care assistance programs applied to the amounts contributed—and not to the amounts reimbursed or available for reimbursement in a particular plan or calendar year. Thus, participants in dependent care assistance programs are able to continue to contribute the maximum amount to their plans for 2021 and 2022. Read [TaxNewsFlash](#)

Notice 2021-26

Today's notice reflects that the IRS and Treasury Department have concluded that "inherent" in the December 2020 legislation (temporarily permitting unused amounts to be carried over to 2021 or 2022, or made available under an extended claims period) is that such amounts that continue to be available are excluded from income if used by the participant for dependent care benefits.

As such, Notice 2021-26 clarifies that dependent care assistant program (DCAP) benefits that would have been excluded from income if used during the tax year ending in 2020 or 2021 remain eligible for exclusion from the participant's gross income and are disregarded for purposes of application of the limits for the subsequent tax years of the employee when the amounts are carried over from a plan year ending in 2020 or 2021 or are permitted to be used pursuant to an extended claims period.

Notice 2021-26 provides several examples illustrating the possible tax consequences of electing \$10,500 in DCAP benefits for a plan year beginning in 2021 but ending in 2022. The examples also illustrate the interaction with the one-year increase in the exclusion for employer-provided dependent care benefits from \$5,000 to \$10,500 for the 2021 tax year under the "American Rescue Plan Act of 2021" (Pub. L. No. 117-2).

Read a related IRS release—[IR-2021-105](#)

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