

DEPENDENT CARE SERVICES - FINAL REGULATIONS

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The IRS has recently issued its final regulations on “Expenses for Household and Dependent Care Services Necessary for Gainful Employment,” which affect reimbursements made under dependent care assistance programs (DCAPs) within cafeteria plans. The regulations were published in the Federal Register on August 14, 2007 and became effective as of that date.

By way of background, dependent care expenses for qualifying individuals¹ may only be reimbursed through a DCAP if they are incurred for the purpose of enabling the employee (and his/her spouse, if any) to be “gainfully employed.” Gainful employment means employment or the active search of employment, unless, for purposes of the spouse, the spouse is incapacitated or is a full-time student (unless education is offered by an organization providing courses exclusively over the internet).

However, over the years, many questions arose as to whether some expenses were deemed to be “employment-related” or were primarily for the “care” of qualifying individuals. The final regulations clear the air with regard to these issues.

Please see below for a summary of the final regulations, some of which require cafeteria plan documents to be amended.

Care of Qualifying Individual:

Costs of Education – The final regulations maintain the position that costs for the care of children in kindergarten and above are primarily educational (ie, not for “care”) and therefore are not

employment-related expenses. However, before and after school programs may be reimbursable as they are primarily for purposes of child-care. The regulations also clarify that expenses of programs below kindergarten may be employment-related expenses even if education is a significant part of the programs.

Specialty Day Camps – The costs of day camp are reimbursable, even if the camp specializes in a particular activity. However, the final regulations clarify that summer school and tutoring programs are not creditable as they are primarily for education, not care.

Overnight Camps – The cost of these camps are not employment-related expenses. The final regulations do not allow any reimbursement, even for the portion of the camp cost attributable to time periods when the parents work. However, this is distinguished in the regulations from “overnight care,” enabling one parent to work the day shift and the other the night shift and have care provided during the night.

Food and Lodging – Expenses for a qualifying individual’s food, lodging, clothing or education are not for “care” and therefore are not reimbursable, unless they are incidental and inseparable from the cost of care.

Transportation – Transportation costs may be reimbursable if the transportation is provided by the dependent care provider to or from the place where the care is provided.

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¹ Qualifying individuals are typically the taxpayers’ children under age 13 or are spouses or dependents incapable of self-care who reside with the taxpayer for over half the year.

Household Services - Services which are minimal or insignificant do not have to be separately allocated from the cost of care. Additionally, such services which are connected with the care of a qualifying individual may be reimbursable.

Caregiver Accommodation Expenses – The additional cost of providing room and board for a caregiver may also be employment-related expenses, including an increase in cost for utilities.

Expenses Enabling Gainful Employment:

Short, Temporary Absences - Expenses are not reimbursable unless they are employment-related expenses (ie, enabling the taxpayer to be gainfully employed or to be actively searching for such employment). The cost of care must be allocated on a daily basis; however, there is an exception for short, temporary absences. The proposed regulations did not state what would constitute a “short, temporary absence;” however, the final regulations include a safe harbor for absences of no more than 2 consecutive calendar weeks. This means that the costs of care incurred while an employee is on leave will likely not be reimbursable to the extent the leave exceeds two weeks. For example, an employee on maternity leave cannot be reimbursed for day care expenses incurred at any time during the leave past the initial first two weeks.

Part-time employment - A part-time employee must allocate the dependent care expenses between days worked and days not worked, unless the employee is required to pay for the dependent care on a periodic basis (such as weekly or monthly), which includes both days worked and not worked.

Divorced / Separated Parents:

The final regulations also incorporate the special dependency rule applying to children of legally separated or divorced parents or parents living apart at all times during the last six months of the calendar year (allowing the non-custodial parent to claim the child for the child tax credit in certain

circumstances). However, for purposes of a DCAP, a child is treated as the qualifying child of the parent with whom the child resides for a longer period of time during the year (ie, the custodial parent). The non-custodial parent may not be reimbursed through the DCAP.

Payments to Related Individuals:

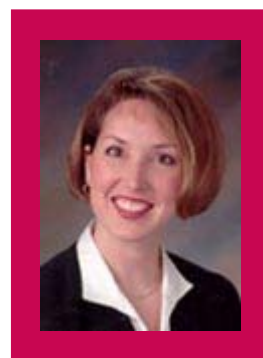
Last, the final regulations state that reimbursements may not be made when the care is provided by certain related individuals, namely:

- the employee’s spouse;
- the parent of a qualifying individual under age 13;
- an individual for whom the employee or spouse may claim an exemption; or
- the employee’s child who is under age 19 at the end of the year in which the dependent care expenses were incurred.

With the release of the Cafeteria Plan Proposed Regulations and now the issuance of the Dependent Care Final Regulations, the IRS has sent the employee benefits world buzzing! Employers will need to pay close attention to all of these rules in order to ensure their plan administration and designs are compliant.

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