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## Potential Impact of COVID-19 on Dependent Care Flexible Spending Arrangements (FSAs)

Dependent care flexible spending arrangements (FSAs) are a benefit that employers may offer employees. They allow employees to pay for certain dependent care services (e.g., child care, summer day camp, babysitting, and adult day care expenses) with pretax dollars. Dependent care FSAs are also referred to as dependent care assistance plans (DCAPs). Employees who participate in a dependent care FSA choose to have a portion of their salary set aside on a pretax basis (i.e., not subject to federal income or payroll taxes), generally up to a maximum of \$5,000 per year. There are other types of FSAs. Health FSAs, for example, allow employees to pay for eligible health care expenses with pretax dollars. For a discussion of health FSAs in the context of the Coronavirus Disease 2019 (COVID-19) pandemic, see CRS In Focus IF11576, *Potential COVID-19 Impacts on Health Flexible Spending Arrangements (FSAs) and Recent Health FSA Changes*.

### Overview of Dependent Care FSAs

Dependent care FSAs are offered to employees as part of a *cafeteria plan*. Under a cafeteria plan, employees are offered the option to set aside a portion of their salary on a pretax basis. Employees then use these contributions to pay for expenses incurred for a *qualified benefit*. Generally, under a dependent care FSA, employees pay out of pocket for the expenses and are then reimbursed from their FSA. By using an FSA, employees reduce the income and payroll taxes they owe. For example, an employee subject to a 22% income tax rate who has \$1,000 of dependent care expenses would save \$296.50 in taxes (\$220 in federal income taxes and \$76.50 in Social Security and Medicare payroll taxes) by paying for those expenses through an FSA rather than paying out of pocket (i.e., with after-tax dollars).

Dependent care FSAs must meet the requirements of *both* Internal Revenue Code (IRC) § 129 and IRC § 125 for an employee to receive the tax benefits associated with contributing to a dependent care FSA. IRC § 129 governs employer-sponsored dependent care benefits broadly. (Employer-sponsored dependent care benefits can be provided in various forms, including as a dependent care FSA, but also on-site child care and direct payments to dependent care providers.) IRC § 125 governs cafeteria plans. These two sections are discussed in more detail below.

### Dependent Care Assistance Program

Under an employer-sponsored dependent care benefit governed by IRC § 129, an employee may contribute up to \$5,000 per year to a dependent care FSA (this maximum applies to all taxpayers who file their taxes as single, head of household, or married filing jointly). This section also defines “dependent care assistance” as expenses for the care

of an employee’s dependent that allow the employee to be gainfully employed (as defined for the child and dependent care credit [IRC § 21]). Dependents may include, but are not necessarily limited to, an employee’s children, elderly parents, or other dependent family members.

### Cafeteria Plan

Under a cafeteria plan governed by IRC § 125, employees typically determine the amount they wish to contribute to an FSA at the beginning of a *plan year*. Plan years are usually annual periods during which employees may contribute to and be reimbursed from an FSA. Once an employee has set the amount he or she wishes to contribute to an FSA for a plan year, changes are allowed only in limited circumstances (like the birth of a child or marriage), generally referred to as a “qualifying life event.” Plan years may begin and end at any point in the calendar year.

Under a cafeteria plan, FSA contributions are subject to a “use-or-lose” rule, whereby employees forfeit any unused contributions remaining in their dependent care FSA at the end of the plan year. Specifically, when an employer chooses to offer a dependent care FSA, it generally must select one of two mutually exclusive options for handling any unused balances at the end of the plan year:

1. employees forfeit unused FSA balances, which then revert to the employer; or
2. employees are given a “grace period” of up to two and a half months after the end of the plan year. Employees can be reimbursed for dependent care expenses incurred during this additional time. At the end of the grace period, unused amounts are forfeited and revert to the employer.

The “use-or-lose” rule ensures that a cafeteria plan is not used to defer compensation (and the taxes paid on that compensation) to a future date, which is generally prohibited under IRC § 125.

Under current law and regulations, employees are not able to “cash out” the balance of an FSA, even if they were to pay taxes on this amount. FSA contributions may only be used to pay for qualified expenses through the plan.

Because cafeteria plans are offered by employers to their employees, individuals may lose access to these benefits when they are laid off or choose to leave a job. Employers may offer some flexibilities to departing employees. Generally, employers may treat unused contributions in a departing employee’s dependent care FSA in the following

ways: (1) any benefits in the departing employee's dependent care FSA revert to the employer; (2) the employer offers a run-off period, in which departing employees may submit for reimbursement expenses that were incurred prior to the employee's departure; or (3) the employer offers a spend-down period, which allows departing employees to continue being reimbursed from funds in their dependent care FSA until the end of the plan year. Employers have the ability to offer departing employees both a run-off period and a spend-down period.

## Impact of COVID-19 on Dependent Care FSAs

The COVID-19 pandemic has considerably affected the market for dependent care. Many child care providers, summer camps, adult day care providers, and other forms of dependent care have been forced to close or reduce the number of individuals they serve due to concerns about the spread of COVID-19. Employees may be working less as a result of the pandemic, or have had work conditions change, reducing their need for dependent care.

The laws and regulations governing dependent care FSAs normally offer little flexibility to employees whose dependent care expenditures change. Under most circumstances, employees are not given the opportunity to reduce or stop their dependent care FSA contributions midyear. If reduced dependent care expenses cause employees to have contributions remaining in their FSAs at the end of the plan year (or grace period, if applicable), they would stand to forfeit that balance.

Employees whose dependent care circumstances have changed due to COVID-19 may be at risk of forfeiting FSA contributions. Consider the following two examples of how employees with dependent care FSAs may be impacted by the pandemic:

*Example 1. An employee contributes \$3,000 per year to a dependent care FSA to pay for their child's summer day camp. The contributions are made in equal payroll deductions each pay period. Due to the COVID-19 pandemic, the camp announced that it will not open at any point this summer. The employee is still slated to make contributions to their dependent care FSA for the remainder of the plan year. The camp is the employee's only dependent care expense, and they now stand to forfeit their \$3,000 in contributions at the end of the plan year.*

*Example 2. An employee contributes the maximum \$5,000 per year to a dependent care FSA to pay for full-time child care for their two children. The FSA plan year ran from May 1, 2019, to April 30, 2020. The employee began working remotely as a result of the pandemic, and has not used child care for several months. As a result, they had a \$1,000 balance remaining at the end of the plan year. Their employer offers a grace period until July 15, 2020, but the employee does not anticipate additional dependent care expenses before that date.*

flexibilities to employers offering certain benefits through cafeteria plans (see IRS Notice 2020-29). These flexibilities allow, but do not require, employers to change some policies related to dependent care FSAs.

First, the IRS notice gives employers the option of allowing employees to make prospective, mid-year amendments to their FSA contributions without the need for a qualifying life event during calendar year 2020. This option would allow employees experiencing reduced dependent care expenditures to lower their FSA elections for the remainder of the plan year, or stop their elections entirely. In the case of the employee in *Example 1*, this flexibility (if offered by their employer) would allow the employee to stop contributions to the dependent care FSA for the remainder of the plan year, limiting the total balance the employee might forfeit at the end of the plan year.

Second, the IRS notice gives employers the ability to extend grace periods for using FSA balances until December 31, 2020. This flexibility applies to dependent care FSAs with either a plan year or a grace period ending in 2020. For example, if a plan year ended on March 31, 2020, an employer could normally offer a grace period up to June 15, 2020. After June 15, employees would forfeit any balance remaining in a dependent care FSA. The IRS notice allows employers to extend that grace period until December 31, 2020, which would benefit employees with existing dependent care FSA balances who expect to have additional dependent care expenses before the end of 2020. In the case of the employee in *Example 2*, this flexibility (if offered by their employer) would allow the employee to use any remaining balance in the FSA for dependent care expenses incurred between July 15, 2020, and December 31, 2020.

## Legislation

Members of Congress have introduced legislation to address issues related to dependent care FSAs and the COVID-19 pandemic. Several bills, including H.R. 6800, H.R. 6958, H.R. 7008, and S. 3972, would give employers the flexibility to allow employees to roll over all contributions to a dependent care FSA from a plan year ending in 2020 to a plan year ending in 2021. If offered by employers, this change would prevent employees from forfeiting unused contributions made to a dependent care FSA in 2020. In the case of the employee in *Example 1*, if allowed by their employer, this change could allow them to apply their 2020 plan year FSA balance toward 2021 plan year expenses. Section 20155 of H.R. 6800 would also allow employers to extend grace periods for a dependent care FSA for up to 12 months after the end of a plan year ending in 2020. This change would allow the employee in *Example 2* to use plan year 2020 FSA balances until April 30, 2021.

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## Recent Executive Branch Activity

To address the impacts of the COVID-19 pandemic, the Internal Revenue Service (IRS) provided temporary

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