

## FBMC Benefits Alert 2005-8

TO	All Clients & Friends of FBMC	DATE	11/22/2005
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RE	<b>DEPENDENT CARE FLEXIBLE SPENDING ARRANGEMENT (DFSA)</b>		

### **Form 2441 & Instructions ( Revised for 2005)**

In our FBMC Benefits Alert 2005-6, we advised that the IRS issued on 09/07/05 IRS Notice 2005-61 to clarify for employers their Form W-2 reporting requirements if an employer amended its cafeteria plan document to provide the new Grace Period (see FBMC Benefits Alert 2005-3) under its DFSA Plan.

As you know, the amount that has been required to be reported in Box 10 of Form W-2 was the total amount of cash reimbursement provided to an employee under a qualified DFSA Plan. In IRS Notice 2005-61, the IRS provided that “[a]n employer that amends its cafeteria plan to provide a grace period for dependent care assistance may continue to...[report] in Box 10 of Form W-2 the salary reduction amount elected by the employee for the year for dependent care assistance (plus any employer matching contributions attributable thereto).”

Unfortunately, the Notice stopped short by being silent on how DFSA participants were to report Grace Period carryover amounts on their Forms 2441 without being taxed on those amounts in the subsequent tax year.

In its revised 2005 Form 2441 and Instructions, the IRS resolved this reporting issue for employees. For a copy of the 2005 Form 2441, visit <http://www.irs.gov/pub/irs-pdf/f2441.pdf>. For a copy of the Instructions, visit <http://www.irs.gov/pub/irs-pdf/i2441.pdf>.

The welcomed news is that participants may treat their DFSA carryover amounts as forfeitures so that their carryover amounts are not taxable to them in the subsequent plan year.

Let's look at an example.

An employee elects to salary reduce \$5,000 annually (based upon his maximum tax filing status) in calendar Plan Year 1. The employee and his spouse have a combined earned income of \$75,000 and plan to file a joint return.

Prior to the new Grace Period ruling, if the employee only used \$4,800 of his \$5,000 for eligible dependent care expenses incurred by the end of PY1, he would have reported the unused \$200 as a forfeiture on his Form 2441. Reporting the unused DFSA funds as a forfeiture meant that he did not exceed his \$5,000 annual amount in PY2 so there was no taxable amount for him to report on his Form 2441.

The new Grace Period ruling, however, permits the same employee to carryover his unused DFSA \$200 from PY1 into PY2 to pay for eligible, dependent care expenses incurred in PY2. Unless the IRS issued similar relief to DFSA participants as it did to employers for their W-2 reporting

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requirements, that \$200 carryover amount would cause the employee to exceed his PY2 annual amount resulting in him having to pay taxes on that \$200.

The IRS recognized this problem and revised its 2005 Form 2441 to address it by treating carryover amounts as forfeitures, too. Using the same employee in our example, this means that he will be able to carry over the \$200 he didn't use in PY1 to pay for eligible dependent care expenses incurred in Plan Year 2. He can again elect to salary reduce \$5,000 annually in PY2. Adding his \$200 carryover amount from PY1 to his \$5,000 annual amount in PY2 will not cause him to exceed his PY2 maximum annual amount because the \$200 will be treated as a forfeiture on the revised 2005 Form 2441. When applying this example to a 2005 Form 2441, it is easier to see the relief provided by the IRS to DFSA participants.

### **Changes to the Definition of "Qualifying Person" in Form 2441 & Instructions (2005)**

In FBMC's Benefits Alert 2004-01, we shared that The Working Families Tax Relief Act of 2004 (WFTRA) had revised the definition of a Code § 152 dependent as well as that of a "qualifying individual" under Internal Revenue Code § 21.

Under WFTRA, this meant that dependent care expenses could no longer be reimbursed under a DFSA Plan for a disabled adult who was incapable of self-care if such person also:

- § received gross income in excess of the exemption amount (\$3,200 in 2005), or
- § was married and filed a joint return with their spouse, or
- § was a dependent of persons who were themselves tax dependents.

There's been Congressional legislation proposing a technical correction to relax these WFTRA requirements for DFSA Plans (as was subsequently done for group health plans) but it hasn't been passed.

However, in its Instructions to the 2005 Form 2441, the IRS has nevertheless made some unexpected changes of its own to the definition of a "qualifying person" that are less restrictive than the definition of a qualifying individual under Internal Revenue Code § 21 when it was revised by WFTRA.

For purposes of completing a 2005 Form 2441, the IRS provides that a qualifying person includes a disabled person not able to care for himself or herself whom a taxpayer can or could claim as a dependent *except* that the person (i) had gross income of \$3,200 or more, or (ii) filed a joint return, or (iii) could be claimed as a dependent on someone else's 2005 return.

Because employers amended their DFSA plan documents to match the revised WFTRA definition of a qualifying individual, neither FBMC nor other industry experts are comfortable at this point with replacing WFTRA's definition of a qualifying individual with the broader definition of a qualifying person that has quietly appeared in the 2005 Form 2441 Instructions. The IRS needs to provide clearer guidance and identify the authority that supports its publishing a less restrictive definition of a qualifying person in its 2005 Form 2441 Instructions than that provided by The Working Families Tax Relief Act of 2004.

### **Dependent Care Tax Credit**

Industry experts caution that the revised 2005 Form 2441 has the potential of allowing a taxpayer-employee to receive tax credit on DFSA carryover amounts *even though* the employee *also* benefited by being able to use those same carryover funds to receive tax-free reimbursements under a DFSA Plan.

To claim the child and dependent care credit, lines 28-32 must be completed on the 2005 Form 2441. As drafted, line 31 does not currently exclude carryover funds that were also used to reimburse expenses under a DFSA Plan during the 2005 tax year.

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