

BENEFITS ALERT 2006-02

To: All Clients & Friends of FBMC	Date: 05/26/06
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Re: Newly Published Proposed Regulations on <i>Dependent Care Expenses</i>	

It's true! On May 24, 2006, the IRS published proposed regulations on **dependent care expenses** to incorporate many of the rules and statutory amendments issued over the past 22 years. They can be accessed by going to: <http://edocket.access.gpo.gov/2006/pdf/E6-7390.pdf>.

Does this mean that plan sponsors have to amend their plan document(s) yet again? No. Whew! We have it on good authority from our outside counsel that the proposed regulations "...do not impact Code Section 129 specific rules and regulations."

So, even though the maximum annual election amount under a Dependent Care FSA plan has not changed yet, there's still much to appreciate about the proposed regulations.

They're written surprisingly in much plainer language and address by reference what expenses qualify for reimbursement under an employer-sponsored Dependent Care FSA plan. They also provide new examples and much needed clarifications using present day circumstances to address some of the administrative challenges faced by plan sponsors.

As proposed regulations, they are subject to change as the IRS reviews comments received from the public. For our purposes, though, they are effective now and can be used for the current plan year if a plan sponsor's plan document defines eligible dependent care expenses as employment-related expenses under Code Section 21, which the Dependent Care FSA plans administered by FBMC do.

We know that in order for a dependent care expense to be reimbursed, it must (among other requirements) be an "employment-related" expense. An expense is not employment-related merely because a participant is paid or it's incurred while they work. To be considered employment-related, the circumstance must be that the participant is unable to go to work unless they make arrangements for dependent care of their qualifying individual(s) to assure the individual(s)' well-being and protection.

Caution: *Not all expenses* relating to a qualifying individual are provided for their care and considered employment-related. If an expense is *partly* for the care of a qualifying individual *and partly* (other than minimal or insignificant) for other goods or services, only the cost for the care of the qualifying individual is an employment-related expense and eligible for reimbursement. Generally, amounts paid for food, lodging, clothing, or education are not for the care of a qualifying individual. But if the care is provided in such a manner that the expenses cover other goods or services that are incidental to and inseparably a part of the care, the full amount may be an employment-related expense.

The proposed regulations provide examples, from which I'm going to borrow. What if a participant (taxpayer) employs a full-time housekeeper to care for her two children, aged 9 (a qualifying individual) and 13 years (who is not a qualifying individual) in order to go to work. The housekeeper cleans, cooks and even drives the participant to and from her place of employment, a trip of 15

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minutes each way. Because she has at least one qualifying individual, the entire expense of employing the housekeeper may be an employment-related expense. In addition, though chauffeur services are not considered to be employment-related, their related cost in this example is too insignificant to separate it out.

Using another example, what if a participant is a member of the armed forces and ordered to a combat zone. To be able to comply with her orders, she places her 10-year old child in a boarding school, which provides education, meals, and housing to her child in addition to dependent care. Only the cost of the boarding school in connection with the dependent care of her child can be reimbursed as an employment-related expense.

Below are some of the rules in the proposed regulations that bear repeating and others that give us more clarity:

- A **qualifying individual** (among other requirements) must reside with the participant for more than one-half of the taxable year.
- A **custodial parent** is defined to be the parent with whom a qualifying child lives for the greater portion of a calendar year.
- Expenses of **pre-school** or similar programs below kindergarten level may be reimbursed as dependent care expenses even if education is a significant part of these programs. Expenses for programs at **kindergarten** level and above, however, are considered to be primarily for education rather than being employment-related expenses, which is why they're not reimbursable.
- Only the cost of **transportation** provided by a *dependent care provider* may be an employment-related expense when taking a qualifying individual to and from a place where their dependent care is to be provided (e.g., a day camp or to an after-school program that's *not* on school premises).
- Expenses for **household services** may be employment-related expenses if they are provided in and about the participant's home and in connection with the care of a qualifying individual. In general, services provided by chauffeurs, bartenders, or gardeners are not household services. See previous examples in this Benefits Alert.
- **Employment taxes** on wages paid to a caregiver for the care of a qualifying individual may be employment-related expenses.
- The additional cost of providing **room and board** for a caregiver over usual household expenditures may be an employment-related expense.
- Indirect expenses such as **application fees, deposits, and agency fees** may be employment-related expenses if the participant is *required* to pay them to obtain the dependent care. *But if the care is not provided* for the qualifying individual, then **forfeited deposits** and other payments cannot be reimbursed (e.g., a deposit reserving a place at a pre-school is forfeited because the child ends up going to a different pre-school).
- If **two or more families** occupy living quarters in common, each of the families is treated as maintaining a **separate household** if *each provides more than one-half of the cost of maintaining the separate households*.
- Because a participant on **paid** or **unpaid leave** is not at work, any dependent care expenses incurred during their leave is *not* employment-related nor reimbursable. However, if a participant is required to pay for dependent care on a *weekly or longer basis*, and takes a **short, temporary absence from work** (e.g., minor illnesses, vacation), they may treat that expense as employment-related.

- Participants employed **part-time** may be reimbursed only for expenses incurred on days they work *unless* they are **required** to pay for dependent care on at least a *weekly or longer basis* that includes both days worked and days not worked. A day on which the taxpayer works **at least 1 hour** is a day of work.
- For each month that a **spouse is a full-time student or incapable of self-care**, he or she is deemed to have earned income of not less than \$250 for one qualifying individual or \$500 for two or more qualifying individuals for the calendar year.
- A **full-time student** is defined in part as pursuing a full-time course of study, which cannot be exclusively at night. (The proposed regulations deleted the night school restriction.)
- Payments to either a **participant's spouse** or to a **parent of the participant's child who is not the participant's spouse** do not qualify for reimbursement. Participants also cannot claim the cost of payments made to their child under age 19 or to someone who is their (or their spouse's) tax dependent. For example, it's okay for grandma to care for a qualifying child as long as grandma is not the participant's (or their spouse's) tax dependent.
- An individual is **physically or mentally incapable of self-care** if, as a result of a physical or mental defect, he or she is incapable of caring for their hygiene or nutritional needs, or require full-time attention of another person for their own safety or the safety of others. *The inability of an individual to engage in any substantial gainful activity or to perform the normal household functions of a homemaker or to care for minor children by reason of a physical or mental condition does not of itself establish that the individual is physically or mentally incapable of self-care.*
- Expenses for **overnight camps** are not employment-related expenses and cannot be reimbursed. The full amount paid for a **day camp** or similar program may be for the care of a qualifying individual even if the camp specializes in a specific activity (e.g., soccer, computers, etc.).
- Work as a **volunteer** or for a nominal consideration is not gainful employment.

Additional Information

Please contact your Account Manager or the undersigned.