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DEPENDENT CARE ASSISTANCE PROGRAMS

By: Matt W. Zeigler, Esq.

With an ever increasing number of both partners of married couples working, and with the amazing statistic that 1990 saw the highest birth rate since the "post-war baby boom", an employers are intensifying their search for ways to accommodate the need for qualified child care for the children of their core employees. Most employers have focused upon available, hopefully geographically close by, "day care" or "after-school care" rather than an "in house" nursery. An ill minor child, no matter the age, when the parent is at work, causes a severe distraction to the employee, loss of productivity, and, generally, will not permit that employee to be at his or her best while working with your customers.

Employers can offer to aid their employees by defraying some of the cost of a good child care program through the use of a tax-free employee benefit called a Dependent Care Assistance Program.

A Dependent Care Assistance Program, as authorized under Section 129 of the Internal Revenue Code, is a way for an employer to pay for some childcare expenses of an employee. That employee will not have to include such payments in his or her taxable income. Since these payments are not included in the gross income of the employee, the employer will not have to pay federal unemployment taxes (FUTA) on these benefits and neither the employee nor the employer have to pay social security taxes (FICA) on the amounts paid. Further, these amounts are not subject to federal or state withholding requirements and, in most cases, state and local taxes.

Our U.S. Congress has kept extending the life of this employee benefit program on a year-by-year basis, and it is currently set to expire December 31, 1991. However, over the past several years, Congress has routinely continued to extend the tax exclusion of these payments. With the likelihood that there will be no significant tax legislation this year, it is difficult to state whether the favorable tax effect of this program will be continued; however, in 1989, tax legislation, passed late in the year, made these same benefits tax excludable retroactively from January 1st of that year. They had previously expired in December, 1988.

Cafeteria Plan Benefit Option. A Dependent Care Assistance Program can be a benefit offered within a cafeteria plan under section 125 of the Internal Revenue Code. Under such an arrangement, the participant may elect to reduce his or her salary by a stated amount. That participant may then use the cafeteria plan dollars set aside to pay for the child care expenses actually incurred during plan year up to the amount of money by which that employee's salary was reduced.

Some employers prefer to have a Dependent Care Assistance Program on the "menu" in a cafeteria plan, so that employees with minor children can make a larger salary reduction than those without minor children. In the absence of a cafeteria plan, if an employer were to make these child care payments to employees with qualifying children, the employees without qualifying children may feel that the employer is unfairly favoring those employees with children over those employees without children.

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Covered Expenses. Expenses that can be paid for and excluded from tax under a Dependent Care Assistance Program, include expenses for the well being and protection of a child age 12 and under, such as:

- nursery school expenses;
- some kindergarten expenses for the care of the child even though some food and education are also provided;
- summer day camp, but not an overnight summer camp;
- an appropriate portion of the expenses of in home maid or cook when caring for a qualified child; and
- that portion of full-time boarding school expenses allocated to the care and welfare of the child, as opposed to the educational costs of tuition and books.

A qualified dependent includes not only young children, but also includes an older dependent, including a spouse, who is incapable of caring for him or herself.

Expenses that do not qualify for tuition assistance include:

- amounts paid for food, clothing or education;
- the cost of first grade or of a higher schooling; and
- the cost of transportation from the employee's home to the site of the care.

The maximum amount of employer paid benefit (or salary reduced dollars in a cafeteria plan) that can be provided tax-free on behalf of an employee is any amount up to \$5,000 per year (\$2,500 if the employee is married and filing separately). However, the amount deductible is limited to the lesser of the \$5,000 or the amount of income earned.

Requirements of the Program. The employer's Dependent Care Assistance Program must be evidenced by a separate written plan. The program must be for the exclusive benefit of employees. The plan must state the requirements for participation or eligibility and include a general description of the dependent care tax credit under Section 21 of the Internal Revenue Code. However, the employer is not required to file for a favorable determination letter as required for a profit sharing or other qualified retirement plan program.

The dependent care tax credit, under section 21 of the Internal Revenue Code, is an existing tax credit for those employees earning less than \$25,000 on an annual basis. These same childcare expenses that can be provided in a formal Dependent Care Assistance Program are also deductible for the employees with this income level even without a formal program. Tax analysts suggest that most lower paid employees are better off paying their own dependent care expenses with after-tax dollars than with the pre-tax dollars in a formal plan or within a cafeteria plan. However, each taxpayer must look at their own individual situation to determine whether to use the dependent care tax credit or the tax-free benefits of the Dependent Care Assistance Program.

Each participant must be furnished a written statement showing the amounts paid or expenses incurred by the employer in providing plan benefit to the participant during the preceding calendar year. The benefit statement must be provided on or before January 31st of each year. The amount indicated on the W-2 Wage and Tax Statement of plan participants will satisfy the notice requirements.

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The only mandatory governmental filing is the annual 5500 return as a fringe benefit plan. However, it is a simplified report. The only information to be required to be reported is the employer identification information, the number of employees receiving the benefits under the plan and the amount of the benefits provided to participants under the plan.

Nondiscrimination Requirements. These plan benefits must meet certain nondiscrimination requirements each year to preserve the exclusion from taxable income. There are two requirements: a classification test and a benefits test. As long as the employer is fairly covering its employees, there is usually no difficulty meeting the tests.

The classification test is satisfied by a review of the facts and circumstances of those employees who actually receive the benefits. If the group of employees receiving the benefits does not discriminate in favor of the highly compensated group of employees, then it will be found to meet this portion of the test. (The section 414(q) definition of highly compensated employees is used for this portion of the test.) Employees that can be excluded from the testing "group" are (1) those employees covered by a collective bargaining agreement; (2) those employees who are less than age 21; and (3) those employees with less than one year of service.

The benefits test compares the benefits provided the highly compensated employees to the same benefits provided to the nonhighly compensated employees. The benefits test uses a different definition of highly compensated employee. This test measures only those benefits provided to stockholders owning a 5% or more interest in the capital stock of the corporation or their spouses or dependents. The test requires that the average benefit provided to the rank and file employees must be at least 55% of the average benefit provided to those highly compensated employees. Employees whose annual income is less the \$25,000 and those whose benefits are provided through a salary reduction cafeteria plan may be excluded from the testing.

Conclusion. A Dependent Care Assistance Program can provide an optional form of benefit for your younger parent/employees that an employer may wish to encourage to stay and grow with your enterprise.