

DEPENDENT CARE FSA OVERVIEW

Tax Savings Example

Dependent Care FSA

Day Care FSA Participant Tax Savings Example

Jill earns \$36,000 annually and has day care expenses for her children that are \$5,000 per year. See below the impact that participating in a Day Care FSA will make on Jill's take home pay!

Without Day Care FSA

Gross Pay	\$36,000
Taxes @ 24.5%	<u>-\$8,820</u>
Net Take Home	\$27,180
Out of Pocket Day Care Costs	<u>-\$5,000</u>
Spendable Income After Day Care Costs:	\$22,180

With Day Care FSA

Gross Pay	\$36,000
Pre-Tax Day Care Deduction:	<u>-\$5,000</u>
Taxable Pay	\$31,200
Taxes @ 24.5%	<u>-\$7,595</u>
Spendable Income After Day Care Costs:	\$23,405

By participating in the Day Care FSA Jill has **increased** her take home pay by **\$1,225** per year!

How does it work?

There are some rules to consider before enrolling in a Day Care FSA.

- Before enrolling in a Day Care FSA, make sure you are eligible to participate.
- The day care expense must be allowing you and your spouse to work, actively look for work or be a full-time student.
- Your dependent must live with you and must be 12 years old or younger. A dependent age 13 or older can be eligible if you can provide proof that the dependent cannot physically or mentally care for himself/herself.
- The care provider cannot be a dependent on your tax return or your child under the age of 19.
- A Day Care FSA works like a bank account. You cannot be reimbursed more than you have contributed to the account year to date.
- Some types of expenses are not eligible. These include tuition for school at the kindergarten level or above, overnight camp, nursing home expenses, meals, activity/supply fees and transportation costs. Montessori tuition is not allowable, however charges from a Montessori school for preschool and before and after school care are allowable (view the section below for more eligible and ineligible expenses.)

The Day Care FSA limit is set by the IRS and is a calendar year limit of \$5000 per family. If your plan year is not on a calendar year, take extra care in calculating your annual election.

To decide on an election amount, estimate your day care expense for the entire plan year and take into consideration any school holidays, breaks and summer vacation. Your election will be taken out evenly from each paycheck.

You can make a change to your annual limit if you have a qualifying event (view the section below). The election change must be consistent with the qualifying event. In addition to the normal list of qualifying events, there are some special events exclusive to the Day Care FSA.

- A change in your day care costs, such as a rate decrease or receiving free day care.
- A change in your need for day care (your spouse loses employment or has a change in work schedule).
- Your dependent ceases to satisfy the eligibility requirements.

Eligibility

More than 2% shareholders of an S-Corp, LLC, Partnerships and Sole Proprietors are not eligible to participate in any aspect of a Section 125 plan. Spouses of these owners who work for the company cannot participate because of the rules of attribution.

Owners of a C-Corp are eligible, but they must hold up to the non-discrimination rules/testing.

Plan eligibility is most often set to match the eligibility rules of the medical insurance plan, but it can be different to exclude groups of employees such as union employees, part-time employees etc.

Domestic Partners are generally not eligible because they do not meet the Code Section 125 definition of a qualified dependent.

Nondiscrimination Testing

Flex-Plan Services provides annual nondiscrimination testing. The Section 125 Plan includes the Premium Conversion Plan (enables employees to pay accident and health plan premiums pretax) and the Health and Day Care FSA. The annual test is conducted at the end of each year. All plans are required to complete end of the year testing to determine whether a plan discriminates in favor of Highly Compensated Employees or Key Employees. No Plan is exempt from testing. Flex-Plan also provides nondiscrimination pretesting at the beginning or middle of the year for plans that anticipate problems passing the tests. The pretest allows employers to make mid-year adjustments to benefits to avoid failing end of the year tests. You are responsible for notifying us if you see any potential problems based on the below information. We can only test what we are made aware of.

NONDISCRIMINATION TESTING – BRIEF EXPLANATION

There are 5 distinct aspects of nondiscrimination testing. The Eligibility Test, Contributions & Benefits Test, Key Employee Concentration Test, the 55% Day Care Average Benefits Test, and the 5% Owner Test.

ELIGIBILITY TEST This test looks at who is asked to participate in the Section 125 plan. You must have at least some non-Highly Compensated Employees eligible to participate in the plan.

CONTRIBUTIONS & BENEFITS TEST This test has several subtests. All employees should receive the same amount of employer contributions, the eligibility rules should be the same for all employees, and the same benefits must be provided to all employees.

THE KEY EMPLOYEE CONCENTRATION TEST This test compares the nontaxable benefits provided to Key Employees to the nontaxable benefit provided to all employees. Nontaxable benefits include the value of the group medical premium, contributions to a Flexible Spending Arrangement, contributions to an HRA or HSA, and contributions to any other benefit provided under the Section 125 Plan. The value of nontaxable benefits provided to Key Employees cannot exceed 25% of the total nontaxable benefits provided under the plan.

55% AVERAGE BENEFITS TEST This test looks at the average Day care benefits provided to Highly Compensated Employees as compared to the average Day care benefits provided to non-Highly Compensated Employees. Know who is participating in your Day Care FSA—plans fail this test most often. If you have HCEs in the Day Care FSA, non-Highly Compensated Employees must receive 55% or more of the benefits under the plan. PLEASE SEE “RED FLAGS” BELOW.

5% OWNER TEST More than 5% Owners cannot elect more than 25% of the total amount elected under the Day Care FSA.

NONDISCRIMINATION TEST RED FLAGS

If your plan contains any of the following situations or plan designs please contact Flex-Plan Services as soon as possible to have your plan reviewed and tested.

- Zero non-HCEs eligible for Premium Conversion Plan or the Health & Day Care FSA;
- The plan excludes a high percentage of employees (part-time, seasonal, hourly employees) or non-HCEs;
- Not all employees receive the same employer contributions;
- KEYs or HCEs receive more employer contributions toward their group medical premium or the FSA than other employees;
- Disparate waiting periods or disparate eligibility requirements (e.g. hourly receive benefits after 90 days, salary after 30);
- Different benefits provided to employees;
- Only 5% Owners participating in the Day Care FSA;
- A high percentage (>25%) of KEYS contributing to the Flexible Spending Arrangement;

- Only HCEs participating in the Day Care FSA; or
Only one participant in the Day Care FSA and that participant is an HCE.

Plans frequently fail the Day Care Test. The plan cannot have only HCEs participating in this portion of the plan or it will fail.

DEFINITIONS

Highly Compensated Employee (HCE)

Whether an individual is a Highly Compensated Employee depends on their status during **the prior plan year** (or the current year in the case of the first year of employment).

- An Officer; or
- An owner owning more than 5% of the Employer, voting power, or value of all classes of stock; or
- An Employee who earned in excess of \$105,000 in the 2008 plan year (for 2009 tests) or \$110,000 in the 2009 plan year (for 2010 tests).
- A spouse or dependent of an individual described above that works for the same Employer.

Key Employee (KEY)

Whether an individual is a Key employee depends on their status during the **prior plan year**.

- An Officer earning more than \$150,000 in the 2008 plan year (for 2009 tests) or \$160,000 in the 2009 plan year (for 2010 tests); or
- A more than a 5% owner; or
- A more than a 1% owner receiving compensation in excess of \$150,000 in the prior plan year.
- Note Government Entities do not have Key Employees.

INELIGIBLE INDIVIDUALS

More than 2% owners of an S-Corp (and their spouse, children, grandchildren, and parents), partners in a partnership, or members of an LLC are not eligible to participate in a Section 125 plan—this includes the premium only plan as well as the Health or Day Care Flexible Spending. In the event these individuals are participating in the plan please promptly remove them and do not consider them for any of the test questions.

OFFICERS

An officer is an employee with the authority of an administrative executive. Thus, if an employee has an officer's title, but does not have the authority, he is not considered an Officer. Similarly, an employee who has the authority but not the title is considered an officer. Whether an individual is considered an Officer is based on all the facts and circumstances (e.g. nature and extent of duties, authority, and continuity of service).

Dependent Care FSA Expenses

Day Care FSA - Non-allowable expenses:

- Daycare for a child aged 13 or older
- Enrichment classes/Summer School
- Kindergarten or school tuition (pre-school and before and after care is okay)
- Meals, supplies, transportation costs*, uniforms costs, diaper fees, etc.
- Nursing Home/Long Term Care expenses
- Overnight camps
- Parents Night Out

*The cost of transportation by a Day care provider of a qualifying individual to or from a place where care of that qualifying individual is provided may be for the care of the qualifying individual. The cost of transportation not provided by a Day care provider is not for the care of the qualifying individual.

Day Care FSA - Allowable expenses

Keep in mind that day care expenses must be for children 12 or younger, unless the child is incapable of self-care.

- **Au Pair:** The costs relating to an au pair for the care of a child are reimbursable.
- **Baby-sitter:** As long as the sitter is not a dependent of the participant, or a spouse, the costs are eligible.
- **Before and after school care**
- **Day Camp:** If not overnight. Only the cost for the child to attend the camp is eligible.
- **Childcare by a relative:** Cannot be a dependent of the plan holder. Must be at least 18.
- **Deposits:** As long as the deposit is for daycare services that will be provided within the plan year the claim is being filed; and the service has been provided. Prorating may be necessary for those services that extend from one year to another.
- **Elder Care:** Costs relating to the care of a dependent adult who is unable to

- care for themselves will qualify only if: 1) such expenses are not attributable to medical services; 2) the elderly person is a qualifying individual; and 3) in the case of services provided outside the employee's household the person still regularly spends at least eight hours each day in the employee's home. Elder day care will often qualify, but 24 hour care in a nursing home will not. We will need a Letter of Medical Necessity.
- **Care of Child Incapable of self-care:** Children 13 and over incapable of self-care will be subject to restrictions as listed above under Elder Care (must spend at least eight hours a day in the home etc.). However, qualifying children under the age of 13 incapable of self-care do not need to spend at least eight hours a day in the employee's home. However, expenses for such children would still have to meet other requirements that could be affected by the amount of time they spend away from home. Please check with your tax advisor or IRS publication 501 and 503. We will need a Letter of Medical Necessity for any child 13 and over.
 - **Extended Day Programs:** Activities provided after school, which are primarily custodial in nature.
 - **FICA and FUTA taxes:** Paid to a daycare provider are eligible.
 - **Field Trips**
 - **Nanny Fees:** Costs relating to the payment of a nanny for the care of a child are reimbursable.
 - **Nursery School/Pre-School/Pre-Kindergarten**
 - **Registration Fees:** As long as the registration fee is for daycare services that will be provided within the plan year the claim is being filed; and the service has been provided. Prorating may be necessary for those services that extend from one year to another
 - **Sick-child care:** Only if they are enabling the parent to go to work.

Change of Status

Participants in the Day Care FSA will be able to make a change to their annual election amount if they have a change of status, some examples of qualifying events are:

Birth
Divorce
Adoption
Death
Change in cost
Change in the need for day care (termination of employment, change in work schedule)
Dependent ceases to satisfy the eligibility requirement.

The change to the annual election amount must be consistent with the change in status, and that change must be acceptable under the Regulations issued by the Department of Treasury.