

IRS Issues Proposed Dependent Care Expense Regulations

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Late last month the Internal Revenue Service issued updated and expanded proposed regulations governing dependent care expenses. While ostensibly focused on the individual income tax credit for dependent care expenses, these proposed regulations will significantly influence the operation of tax-free dependent care assistance programs and will lead to modifications in communications related to dependent care spending accounts.

Background

The proposed regulations update regulations from 1979 to reflect seven significant laws, interim IRS pronouncements about the operation of the dependent care expense credit, and even a change in the Code section applicable to the credit. The proposed regulations are generally more expansive than prior guidance and may lead to greater use of dependent care spending accounts. The proposed regulations also attempt to reflect the modern realities of dependent care provider payment requirements, workforce trends, and the role of women in the workplace.

Now, as a result of the proposed regulations, there will be a single source for the current rules governing the dependent care credit—and many of these rules are also used by employers to administer the terms of their dependent care spending account plans. The proposed rules will apply to taxable years ending after they are issued as final regulations, but they may be applied to current dependent care spending account issues.

Employers should review their current dependent care spending account operations, particularly their 2007 dependent care spending account communication materials, to be certain that their current operations and future enrollment materials reflect the proposed regulations.

What's New or Clarified in the Proposed Regulations?

The proposed regulations have been moved to Code section 21 and contain a number of new or clarified concepts. Beyond changes that are unique to the dependent care credit, the proposed regulations:

- Clarify that expenses are only eligible in the later of the year in which the services are provided or the year the expenses are paid;
- State that kindergarten expenses are primarily for education and are not eligible expenses;
- Permit expenses for specialty day camps, such as soccer camp or computer camp;
- Allow employees to treat limited transportation expenses incurred by a dependent care provider as employment-related expenses;

- Recognize that indirect expenses such as application or agency fees may be eligible for reimbursement;
- Require allocating expenses on a daily basis to determine whether the expenses are employment-related (but also create administrative convenience rules for minor illness, vacations, and part-time workers who are required to pay for dependent care on a weekly or longer basis);
- Remove the prior prohibition on night school qualifying as a full-time course of study; and
- Clarify that payments made to the taxpayer's spouse or the child's parent do not qualify as eligible expenses.

Housekeeping Revisions

The proposed regulations incorporate many interim legislative changes and serve as a handy reminder of the significant changes to Code section 21 over recent years. Some of these changes may not have made their way into companies' dependent care spending account communications and operations, including:

- Updating the definition of a dependent;
- Reducing the maximum age to 13;
- Increasing the deemed earned income for spouses who are full-time students or incapable of self-care;
- Revising special rules for divorced or custodial parents; and
- Replacing household maintenance with "same principal place of abode" requirements.

Next Steps

Employers who offer dependent care spending accounts or provide other dependent care assistance programs, such as tax-free or subsidized on-site day care, should carefully review the proposed regulations. Our many years of experience with cafeteria plans and dependent care spending accounts uniquely position Morgan Lewis to help review the current operation of dependent care spending accounts, review and expand 2007 open enrollment materials to reflect these changes and reemphasize the benefits of dependent care spending account participation, and even work through ongoing administrative questions surrounding the operation of dependent care spending accounts.

For more information about the proposed regulations, please contact any of the Morgan Lewis attorneys listed below.

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