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Treasury and IRS Address Dependent Care Form W-2 Reporting

For New 2-1/2-Month Grace Period

October 7, 2005

On September 7, 2005, the Treasury Department and the IRS published Notice 2005-61, which addresses Form W-2 reporting requirements for employers who amend their cafeteria plan to take advantage of the new 2-1/2-month grace period. The new opportunity (created by Notice 2005-42, click here to view the LawFlash detailing the contents of the prior Notice) allows employers to amend their cafeteria plan documents before December 31, 2005 to add a grace period of up to 2-1/2 months following the end of each plan year, when unused balances in spending accounts can be used to pay or reimburse expenses incurred during the new grace period. This modification to the traditional "use it or lose it" rule created a number of dependent care spending account issues, the most important of which has now been favorably and simply resolved by Notice 2005-61.

Notice 2005-61 allows employers who adopt the 2-1/2-month grace period to report in Box 10 of Form W-2 the annual amount of participant (plus any employer) contributions to the dependent care spending account—regardless of whether some of those contributions are used to pay expenses incurred in the first 2-1/2 months of the following year. Further, for the following year, an employer need only report, in Box 10 of Form W-2, the annual amount of contributions into the dependent care spending account for that year. For example, assume that a participant contributes $5,000 to a dependent care spending account for each of 2005 and 2006. If the participant has $500 remaining in the account at the end of 2005, and uses the $500 for expenses incurred during the first 2-1/2 months of 2006, the employer is permitted to report $5,000 in Box 10 of the 2005 Form W-2 and $5,000 in Box 10 of the 2006 Form W-2.

This simplified reporting approach is an extension of guidance provided by Notice 89-111, which allows employers to report participant and employer contributions (instead of actual reimbursements) on Form W-2. This earlier notice grew out of the problem created by the need to prepare Form W-2 well before the deadline (usually the end of March) for submitting and receiving reimbursement of dependent care expenses incurred before the end of a plan year.

Now that the IRS has favorably resolved the Form W-2 reporting issue for dependent care spending accounts, employers will be much more likely to adopt the new 2-1/2-month grace period. Before doing so, employers should be certain that their spending account administrators are able to handle the grace period and have adopted clear rules addressing payment priorities for claims incurred during the first 2-1/2 months of a plan year. Then, after communicating the new opportunity to participants during the 2006 open enrollment period (so employees can adjust their 2006 elections accordingly), employers must be certain to review and amend their cafeteria plans by December 31, 2005 to add the grace period. Last, employers will also likely push back the traditional deadline for submitting claims for reimbursement to reflect the 2-1/2-month grace period.

If you would like further information regarding the issues raised in this Morgan Lewis LawFlash, or would like assistance in amending plans, please contact your regular Morgan Lewis attorney, or any of the following:

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