



Want to Offer a Dependent Care FSA to Employees? Some May Owe More Tax by Contributing

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The Basics of Dependent Care FSAs

- Among the many tax-advantaged benefits employers may offer their employees is a dependent care flexible spending account (FSA) under Internal Revenue Code Section 129.
- A dependent care FSA allows employees to pay for dependent care on a pre-tax basis.
- In 2024, single filers and married couples filing jointly can contribute up to \$5,000 to a dependent care FSA. (The contribution limit is \$2,500 for married filers filing separately.)
- Employees elect how much to contribute at the beginning of each year and unused amounts may not be carried forward to future years.

Tax Savings of Dependent Care FSAs

- The tax savings offered by a dependent care FSA can be substantial.
- For example, a family might save \$600 in tax as follows:
 - The Barkers are a married couple filing jointly with two children.
 - They pay \$5,000 per year, per child, in qualifying childcare expenses.
 - They have \$80,000 in taxable income and therefore a 2024 marginal federal income tax rate of 12%.



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- If the Barkers contribute the maximum \$5,000 to a dependent care FSA, they will pay \$5,000 of their childcare expenses with pre-tax instead of post-tax dollars. This would save them \$600 (0.12 marginal tax rate x \$5,000 income exclusion).

Unintended Tax Consequences of Dependent Care FSAs

- While the tax savings offered by a dependent care FSA are appealing, they come with a potential trap for the unwary: reduced eligibility for the dependent care tax credit under Internal Revenue Code Section 21.
- Taxpayers can owe *more* taxes by contributing to a dependent care FSA than they would have otherwise owed.
- This odd result follows from the basics of the dependent care credit under Section 21:
 - The credit is calculated as a percentage of qualifying expenses for household services or dependent care.
 - Qualifying expenses are capped at \$3,000 for one dependent and \$6,000 for two or more dependents. But this cap is reduced by the amount contributed to a dependent care FSA.
 - The maximum percentage of qualifying expenses that can be credited is 20% for taxpayers whose adjusted gross income is over \$43,000.
- As a result of these rules, the family from our previous example might owe \$400 *more* in taxes by contributing to a dependent care FSA:
 - The Barkers pay \$10,000 in total childcare expenses. This means that they would ordinarily be entitled to a dependent care credit of \$1,200 (0.2 credit percentage x \$6,000 maximum allowable expenses).
 - But here is the catch: The cap on qualifying expenses for the dependent care credit (which would otherwise be \$6,000 for the Barkers) is reduced by their \$5,000 contribution to a dependent care FSA.
 - This means that only \$1,000 of the Barkers' childcare expenses qualify for the dependent care credit, leaving them with a reduced credit of only \$200 (0.2 credit percentage x \$1,000 maximum allowable expenses post-reduction).
- Overall, then, by contributing to the dependent care FSA, the Barkers save \$600 (from the dependent care FSA) plus another \$200 (from the dependent care credit) for a total of \$800.
- This is significantly less than the \$1,200 they would have saved had they *not* participated in a dependent care FSA, because the dependent care FSA benefits came at the cost of full eligibility for the dependent care credit.

Implications



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- Like all benefits decisions, the decision to offer a dependent care FSA depends in large part on the demographics of one's workforce.
- Taxpayers who earn more than the Barkers in our example might benefit from contributing to a dependent care FSA despite the resulting reduction in their dependent care credit.
- Ultimately, benefits departments should work carefully with their advisors and plan participants to ensure that the programs they implement meet their intended objectives - it would be a shame to spend time and money on a tax-savings program that ends up *costing* employees more than it saves them.