



September 21, 2026

IRS issues proposed regulations on DCAP nondiscrimination testing

Background

On August 11, 2026, the Department of the Treasury and the Internal Revenue Service (IRS) issued [proposed regulations](#) addressing the nondiscrimination testing rules that apply to dependent care assistance programs (DCAPs) under Internal Revenue Code (IRC) §129. These proposed regulations mark the first time the IRS has issued guidance on these nondiscrimination testing rules, which originally took effect over 45 years ago.

As a refresher, the purpose of the nondiscrimination testing rules under IRC §129 is to ensure employers are not treating highly compensated employees (HCEs)¹ more favorably than non-highly compensated employees (non-HCEs) with respect to employer-sponsored DCAPs. While IRC §129 outlines the nondiscrimination requirements for DCAPs, it lacks meaningful guidance on how to apply those rules in practice when determining whether a DCAP is discriminatory. The proposed regulations expand on the statutory framework and reflect a practical approach that some employers have already been applying in the absence of specific guidance.

The proposed regulations would apply to plan years beginning on or after the date the IRS publishes final regulations. However, employers may rely on the proposed regulations before the final regulations are published. The comment period is open through September 25, 2026, and the IRS has scheduled a public hearing for October 15, 2026.

This Alert is relevant for all employers offering DCAPs.

Existing landscape of DCAP testing

IRC §129 permits employees to exclude from gross income up to \$7,500 per year (\$3,750 for married individuals filing separately) of DCAP contributions, so long as the DCAP satisfies four nondiscrimination requirements. If a DCAP fails any of these tests, HCEs lose the tax-free treatment of those benefits, while non-HCEs are not affected and may continue to claim the exclusion.

¹ The proposed regulations define an HCE by cross-reference to [26 U.S. Code § 414\(q\)](#)

Highlights

Overview

On August 11, 2026, the IRS issued proposed regulations under IRC §129 addressing nondiscrimination testing for dependent care assistance programs (DCAPs).

The proposed regulations clarify much of the ambiguity under IRC §129, including introducing favorable criteria for the average benefits test, establishing an eligibility safe harbor, and creating a year-end W-2 remediation mechanism to correct certain nondiscrimination testing failures.

This Alert is relevant for all employers offering DCAPs.

Employer Action

- Employers offering DCAPs should review current plan design, eligibility rules, and testing practices against the proposed framework with their DCAP testing vendor.
- The proposed regulations would apply to plan years beginning on or after the date final regulations are published, but employers may rely on them in the interim.

The proposed regulations also provide guidance on Trump Accounts. That guidance is not addressed in this Alert. For information on Trump Accounts, we recommend consulting with retirement plan counsel.

Under IRC §129, DCAPs must satisfy four nondiscrimination tests:

- The eligibility test;
- The owner concentration rule;
- The average benefits test; and
- The contribution and benefits test.²

IRC §129 establishes the basic structure of these four tests but leaves much of the testing methodology unclear—most notably, the appropriate denominator for certain required calculations, benefit measurement, employee exclusions, timing, and year-end workforce changes. In the absence of specific guidance, employers have frequently relied on differing assumptions and interpretations of IRC §129, which can yield contradictory testing results for the same DCAP.

Key elements of the proposed regulations

The proposed regulations address these longstanding gaps in IRC §129 by clarifying the specific mechanics needed to apply the four nondiscrimination tests. Further, the proposed regulations make clear which employees are excluded from certain tests, when testing must be satisfied, and by establishing correction methods for certain testing failures. The following paragraphs discuss each of these proposed changes in greater detail.

Eligibility test

IRC §129

Under the eligibility test, classifications of employees established by an employer for coverage under a DCAP must not discriminate in favor of HCEs. IRC §129 requires a classification “found by the Secretary not to be discriminatory,” but the Secretary of the Treasury had never actually issued the framework for making that determination. No safe harbor existed, and no numerical benchmark told employers whether their eligibility structures were compliant.³

Proposed regulations

The proposed regulations interpret IRC §129 to require an eligibility classification be reasonable, based on objective business criteria, and nondiscriminatory under either a facts-and-circumstances test or a numerical safe harbor. That is, the proposed regulations essentially create two tests a DCAP must satisfy to pass the eligibility test: (1) the reasonable eligibility determination; and (2) the nondiscriminatory classification.

Reasonable eligibility determination

To satisfy the reasonable eligibility determination, an eligibility classification must be based on all facts and circumstances, reasonable, and established under objective business criteria. The proposed regulations provide that reasonable classifications may include specified job categories, nature of compensation (salaried or hourly), geographic location, and similar bona fide business criteria.

Nondiscriminatory classification

In addition to satisfying the reasonable eligibility determination, the proposed regulations provide that the classification must also be nondiscriminatory, which means that it must satisfy either (1) a numerical safe harbor, or (2) a facts-and-circumstances test:

² [26 U.S. Code §129](#)

³ Practitioners often leveraged concepts from the qualified plan nondiscrimination rules under IRC §129 410(b), but no authority confirmed that this application was appropriate.

- **Numerical safe harbor:** A classification would automatically be treated as nondiscriminatory if the plan's "ratio percentage" (the percentage of eligible non-HCEs divided by the percentage of eligible HCEs) meets or exceeds a safe harbor threshold. That threshold starts at 90% and decreases by three-fourths of a percentage point for each whole percentage point by which the non-HCE concentration percentage exceeds 60%.
- **Facts-and-circumstances test:** If the numerical safe harbor is not met, the classification can still satisfy the nondiscriminatory classification if, based on all facts and circumstances, the classification is nondiscriminatory. No one factor is determinative, and relevant factors include:
 - The underlying business reason for the classification;
 - The percentage of the employer's employees eligible (the higher the percentage, the more likely the classification is nondiscriminatory);
 - Whether the number of eligible employees in each salary range is representative of the number of employees in each salary range of the employer's workforce; and
 - The difference between the plan's ratio percentage and safe harbor percentage (explained above).

Owner concentration rule

IRC §129

The owner concentration rule provides that not more than 25% of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for individuals who are considered principal shareholders or owners (and their spouses and dependents). A principal shareholder or owner is an individual who owns more than 5% of the stock or of the capital or profits interest in the employer on any day of the year.

Proposed regulations

The proposed regulations are consistent with IRC §129 and do not make any substantive changes to the testing mechanics of the owner concentration rule. To determine whether a DCAP satisfies the owner concentration rule, an employer's DCAP assistance provided to more-than-5% shareholders or owners is divided by all DCAP assistance provided by the employer, and this number cannot exceed 25%.

While the mechanics of the owner concentration rule remain the same, the proposed regulations provide remedial measures due to a failure of the owner concentration rule (see [Failure and remediation](#)).

Average benefits test

IRC §129

For a DCAP to satisfy the average benefits test, the average benefits provided to non-HCEs "under all plans of the employer" must equal at least 55% of the average benefits provided to HCEs "under all plans of the employer."

Because HCEs forfeit their tax exclusion under the DCAP if the plan fails nondiscrimination testing, many employers used a conservative testing approach consistent with the statute that counted all eligible employees in the denominator. This approach lowered the non-HCE average—since many eligible non-HCEs elected zero benefits—making the test significantly harder to pass. Other employers took a narrower approach, counting only actual participants, which produced markedly different results. Absent clarifying guidance, however, both approaches left employers' DCAPs exposed to the risk of nondiscrimination failures. As a result, employers were often reluctant to increase DCAP contribution limits under the One Big Beautiful Bill Act.⁴

⁴ The One Big Beautiful Bill Act increased the annual DCAP pre-tax contribution limit from \$5,000 to \$7,500 beginning January 1, 2026.

Proposed regulations

One of the most helpful provisions in the proposed regulations addresses the longstanding uncertainty regarding the employees who are included in the average benefits test. Specifically, the average benefit for each group—HCEs and non-HCEs—is determined by dividing the total dollar amount of benefits provided to employees in that group during the plan year by the number of employees in that group who received benefits greater than zero. *Employees who were merely eligible to participate but did not elect or receive benefits are excluded from the denominator.*

The proposed regulations also clarify that “all plans of the employer” is limited to all DCAPs of the employer. Additionally, for benefits made available through salary reduction, employers may exclude from the average benefits test calculation employees whose compensation is less than \$25,000.

As to timing, the proposed regulations would require the average benefits test to be satisfied as of the last day of the plan year. And, similar to the owner concentration rule, the proposed regulations provide remedial measures due an average benefits test failure (see [Failure and remediation](#)).

Contributions and benefits test

IRC §129

Under IRC §129, a DCAP may not discriminate in favor of HCEs with respect to contributions or benefits. In practice, the more common compliance challenge is not plan design, but participation disparity. Because DCAPs are generally funded entirely through salary reduction, non-HCEs frequently participate at lower rates than HCEs, often due to affordability constraints or the absence of qualifying dependent care expenses.

Consequently, even a facially neutral plan offering equal election opportunities to all employees may nonetheless fail the contributions and benefits test when HCE utilization is disproportionately high relative to non-HCE utilization. Moreover, no clear authority has established that equal opportunity to elect benefits alone satisfies the contributions and benefits test where utilization is skewed, leaving employers exposed despite facially equal plan terms.

Proposed regulations

The proposed regulations provide helpful guidance on this point: a DCAP satisfies the contributions and benefits test where the benefit is available on the “same terms” to all eligible employees. Under this standard, a DCAP that permits every non-HCE to elect salary reductions up to the same maximum available to HCEs is not discriminatory merely because actual contributions, elections, or utilization ultimately differ across the workforce. Instead, the test turns on uniformity of the benefit election offered to employees, not on the outcomes of their elections.

Excluded employees

Consistent with IRC §129, the proposed regulations identify employees who may be excluded from two of the four required nondiscrimination tests. These excluded employees are:

- Employees under age 21 who have not completed one year of service, and
- Employees who are excluded from the DCAP and covered by a collective bargaining agreement, so long as DCAP benefits were the subject of good-faith bargaining.

Employers may exclude these employees for purposes of applying the eligibility test and the average benefits test, but not when applying the owner concentration rule or the contributions and benefits test.

Failure and remediation

IRC §129 does not provide a year-end correction mechanism for nondiscrimination failures under any of the four required tests. The proposed regulations, however, fill this gap in part, offering remediation measures for failures of two of the four tests: the average benefits test and the owner concentration rule.

If a DCAP fails the average benefits test, an employer may correct the failure by including the “excess benefit”—determined under a prescribed formula—as taxable income on the Form W-2 of each affected HCE, furnished by the applicable Form W-2 deadline (typically January 31) immediately following the year in which the failure occurred. A failure of the owner concentration rule follows the same corrective approach: the employer includes the “excess ownership concentration,” again determined under a prescribed formula, as taxable income on the Form W-2 of each affected owner or shareholder, furnished by that same deadline.

Note: According to the preamble, the IRS proposed these regulations to give employers a practical correction mechanism for testing failures while maintaining the IRC §129’s emphasis on preventing highly compensated employees from benefiting from discriminatory plan designs. Rather than requiring employers to adjust benefits that have already been provided, the proposed regulations would permit certain failures to be corrected through income inclusion.

Next steps

As of the publication date of this Alert, the proposed regulations have not been finalized, and employers are not required to take any action in response to the proposed regulations. However, employers sponsoring DCAPs may rely on the proposed regulations when performing nondiscrimination testing before the final regulations are published.

Employers offering DCAPs should consider reviewing eligibility classifications for objective and reasonable business criteria and confirming whether contributions and benefits are offered on the same terms to similarly situated eligible employees. Employers should also evaluate how the new average benefits test methodology may affect testing results, particularly if the employer has historically failed the average benefits test (this is common). If an employer has already conducted testing for its DCAP for the 2026 plan year and failed one or more of the four required tests, the employer should confirm whether current testing practices should be updated in reliance on the proposed regulations, as well as coordinating with applicable administrators and payroll providers regarding the proposed correction methods.

About the authors



Tarin Russell, J.D. is a Senior Compliance Consultant with the Marsh McLennan Agency's Employee Health & Benefits Compliance Team.



Stacey Stewart, J.D., LL.M in Taxation. is a SVP & Senior Compliance Consultant with the Marsh McLennan Agency's Employee Health & Benefits Compliance Team.

The information contained herein is for general informational purposes only and does not constitute legal or tax advice regarding any specific situation. Any statements made are based solely on our experience as consultants. Marsh McLennan Agency LLC shall have no obligation to update this publication and shall have no liability to you or any other party arising out of this publication or any matter contained herein. The information provided in this alert is not intended to be, and shall not be construed to be, either the provision of legal advice or an offer to provide legal services, nor does it necessarily reflect the opinions of the agency, our lawyers or our clients. This is not legal advice. No client-lawyer relationship between you and our lawyers is or may be created by your use of this information. Rather, the content is intended as a general overview of the subject matter covered. This agency is not obligated to provide updates on the information presented herein. Those reading this alert are encouraged to seek direct counsel on legal questions. © 2025 Marsh McLennan Agency LLC. All Rights Reserved.