National Compliance Update
USI EMPLOYEE BENEFITS

August 20, 2026

Proposed Rule Addresses DCAP Nondiscrimination Testing

On August 11, 2026, the Treasury and Internal Revenue Service (“IRS”) issued a proposed rule addressing employer contributions to Trump accounts and nondiscrimination rules for dependent care assistance programs (“DCAPs”).

> ***USI Note***. This article discusses the nondiscrimination rules for DCAPs. For information on Trump Accounts, see our prior Compliance Update.[1]

The proposed rule provides some of the first regulatory guidance as it relates specifically to DCAP nondiscrimination testing. Fortunately, the rule provides:

- Much needed clarification of the nondiscrimination tests required under Code Section 129 for DCAPs;
- Helpful guidance that makes it easier for employers to satisfy the 55% average benefits test, a test that is commonly failed; and
- Examples to illustrate how the testing works in practice.

This guidance is helpful and timely given the recent statutory increase in the DCAP limit to $7,500 for plan years beginning in 2026. Many employers were concerned that offering a higher DCAP limit could increase the risk of nondiscrimination testing failures.

The rule is currently proposed and will go through the relevant notice and comment period. However, it may be relied upon until final guidance is issued.

BACKGROUND

Generally, DCAPs cannot discriminate in favor of highly compensated employees (“HCEs”). HCEs are defined as employees who:

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[1] See USI’s Compliance Update, Proposed Rule Addresses Employer Contributions to Trump Accounts (August 13, 2026).

- had compensation during the preceding plan year exceeding $160,000 (adjusted annually) or
- were more-than-5% owners at any time during the current or preceding plan year.[2]

A non-HCE is an employee who is not an HCE.

To satisfy this requirement, a DCAP must satisfy four nondiscrimination tests: (1) Contributions and Benefits, (2) Eligibility, (3) Owners Concentration and (4) 55% Average Benefits Test.

If a DCAP fails nondiscrimination testing, the amounts received by HCEs for dependent care assistance are no longer excludable and must be included in the HCE's gross income. There is no impact to non-HCEs.

DCAP NONDISCRIMINATION TESTING

The proposed rule provides helpful clarification on DCAP nondiscrimination testing.

Contributions & Benefits Test

The contributions or benefits provided under a DCAP must not discriminate in favor of HCEs or their dependents. A plan that provides benefits on the same terms for all eligible employees satisfies this requirement.

Eligibility Test

The DCAP must benefit employees who qualify under an eligibility classification that is: (1) reasonable based on objective business criteria, and (2) does not discriminate in favor of HCEs.

For this purpose, an employee is eligible for a DCAP only if the employee has a meaningful opportunity to receive benefits, via salary reduction or otherwise, regardless of whether any benefits were received.

1. *Reasonable classification*. Any eligibility classification must be reasonable based on established objective business criteria, such as job categories, nature of compensation (e.g., salaried/hourly) or geographic location.
2. *Nondiscriminatory classification*. This can be satisfied through one of two tests:
    - *Facts and Circumstances*. Looking at all the facts and circumstances, the classification is nondiscriminatory. Not one factor is determinative in this analysis, but relevant factors include:
        - The underlying business reason for the classification.
        - The percentage of employees eligible under the plan (the higher the percentage the less likely to be nondiscriminatory).
        - Whether the number of employees eligible under the plan in each salary range is representative of the number of employees in each salary range of the employer's workforce.
        - How close the plan comes to satisfying the numerical safe harbor.

[2] IRS Code Sec. 414(q).

    - *Numerical Safe Harbor*. The numerical test provides that a plan is not discriminatory if the plan's ratio percentage (the ratio of non-HCE participation to HCE participation) is greater than or equal to an employer's applicable safe harbor percentage.
        - The ratio percentage is calculated by dividing the eligibility percentage of non-HCEs (number of eligible non-HCEs ÷ total number of non-HCEs) by the eligibility percentage of HCEs (number of eligible HCEs ÷ total number of HCEs).
        - The safe harbor percentage is 90% (with some reductions).[3]

The following employees are excluded from the eligibility testing:

- Employees who have not attained the age of 21 and have not completed one year of service; and
- Employees covered by a collective bargaining agreement where the benefits were negotiated in good faith.

Owners Concentration Test

Not more than 25% of the total dependent care benefits provided during the year may be provided to individuals who own more than 5% of the employer (or their spouses or dependents).

The rule clarifies that if this test fails, a plan may still correct the failure by including in income any excess ownership contribution to the affected owner under a prescribed formula on their Form W-2 for the applicable year.

55% Average Benefits Test

The average benefit provided to non-HCEs must equal at least 55% of the average benefit provided to HCEs.

Importantly, the proposed rule clarifies that for purposes of this test only count those employees who are receiving benefits from the DCAP. *Employees who are eligible but do not elect to participate can be excluded from the calculation*. This is a significant clarification and should help improve the ability for these arrangements to pass the 55% average benefits test.

The proposed rule also confirms that employers may correct failures by including the excess benefits in income of the affected HCE before the Form W-2 reporting deadline for the year in which the excess benefits were provided.

How is the average benefits test run?

Step 1. Calculate the average benefit provided to HCEs: Total DCAP benefits received by HCEs / number of HCEs who received the benefit.

Step 2. Calculate the average benefit provided to non-HCEs: Total DCAP benefits received by non-HCEs / number of non-HCEs who received the benefit.

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[3] The safe harbor percentage of an employer is 90 percent, reduced by ¾ of a percentage point for each whole percentage point by which the non-HCE concentration percentage exceeds 60 percent.

Step 3. Average benefit of non-HCEs ÷ Average benefit of HCEs is > 55%, the plan will pass.

Example 1 – 55% Test Satisfied.
ABC company has 15 HCEs and 15 non-HCEs in 2026. ABC maintains a DCAP funded solely by employee pre-tax salary reduction elections through a cafeteria plan. All 30 employees are eligible to make DCAP contributions on the same plan terms. 11 HCEs elect DCAP benefits of $7,500. 4 non-HCEs elect DCAP benefits of $7,500. The remaining employees do not elect DCAP benefits.
The average benefit provided to HCEs is $7,500 and the average benefit provided to non-HCEs is $7,500.[4] The average benefit provided to non-HCEs is 100% of the average benefit provided to HCEs and exceeds the 55% threshold. *This plan passes the 55% benefits test*.
Example 2 – 55% test not satisfied, with corrections.
Same facts as example 1 except: ▪ 11 HCEs elect DCAP benefits of $7,500. ▪ 7 non-HCEs elect DCAP benefits in different amounts. – 1 non-HCE elects $7,500 – 3 non-HCEs elect $5,000 – 1 non-HCE elects $2,500 – 2 non-HCEs elect $1,000
The average benefit provided to HCEs is $7,500. The average benefit provided to non-HCEs is $3,857.14. The average benefit provided to non-HCEs is 51.4% of the average benefit provided to HCEs ($3,857.14/$7,500). *The plan does not pass the 55% average benefits test*.[5] However, before the furnishing deadline for Form W-2 for the year in which the benefits were provided, the employer treats $500 of the benefits elected by each HCE as gross income and wages for the year. This reduces the average benefit provided to the HCEs for the year from $7,500 to $7,000. Accordingly, the average benefit provided to the non-HCEs is 55.1% ($3,857.14/$7,000) of the average benefit provided to HCEs and the average benefits test is satisfied.

The following employees are excluded from the 55% average benefits testing:

- Employees who have not attained the age of 21 and have not completed one year of service;
- Employees covered by a collective bargaining agreement where the benefits were negotiated in good faith; and

[4] HCEs: $7,500*11 = $82,500. 82,500/11 = $7,500 – average benefit HCEs
Non-HCEs: $7,500 * 4 = $30,000/4 = $7,500 – average benefit non-HCEs
$7,500 avg. benefit non-HCEs/$7,500 avg. benefit HCEs = 100% > 55% = **pass**

[5] HCEs: $7,500*11 = $82,500. 82,500/11 = $7,500, average benefit HCEs
Non-HCEs ($7,500+$5,000+$5,000+$5,000+$2,500+$1,000+$1,000) = $27,000/7 = $3,857.14, average benefit non-HCE
$3,857.14 avg. benefit non-HCE/$7,500 avg. benefit HCE = 51.4% < 55% = **fail**

- Employees with compensation below $25,000.

WHEN TO RUN THE TESTS?

The rule confirms nondiscrimination testing must be satisfied as of the last day of the plan year.

However, it's best to consider earlier testing so that corrections can be made in the event of a testing failure and excess contributions.

EMPLOYER NEXT STEPS

The proposed rule is welcome news to provide better guidance and clarification on DCAP testing. It may be relied upon until a final rule is published. Employers will want to coordinate with their DCAP administrators to understand changes in DCAP testing processes to align with the new guidance.

RESOURCES

- For a copy of the proposed rule, visit https://www.federalregister.gov/documents/2026/08/11/2026-16314/employer-contributions-to-trump-accounts-and-nondiscrimination-rules-for-dependent-care-assistance