PPi BENEFIT SOLUTIONS

DEPENDENT CARE ASSISTANCE PROGRAM NONDISCRIMINATION RULES: A GUIDE FOR EMPLOYERS

In order to qualify for Section 129 tax exclusions, a DCAP must satisfy certain nondiscrimination rules. These rules generally prohibit plan designs that intentionally or unintentionally favor highly compensated employees.

A Dependent Care Assistance Program (DCAP), also known as a dependent care flexible spending arrangement (DCFSA), is an employer-sponsored plan that can pay or reimburse dependent care expenses incurred by the employee to enable both the employee and their spouse to work or look for work. Provided under Section 129 of the Internal Revenue Code, eligible expenses must relate to the care of the employee's child under age 13, or of a spouse or other dependent who lives with the employee and is unable to care for themselves.

Effective January 1, 2026, the One Big Beautiful Bill Act (OBBBA) increases the maximum annual DCAP tax exclusion from $5,000 to $7,500 (single or married filing jointly), and from $2,500 to $3,750 (married filing separately). The maximum annual exclusion is measured per calendar year (regardless of whether the employer administers the plan according to a non-calendar plan year) and is applied per household, not per employee. So, if both spouses have access to a DCAP through their respective employers, their combined contributions cannot exceed the applicable limit. For example, in 2026, if one spouse elects $4,000 in DCAP benefits, the other may not elect more than $3,500.

PPI Observation	Although not required, it is generally more practical to administer DCAPs on a calendar year basis, even if other employer-sponsored benefits follow a non-calendar year. Calendar year administration of DCAPs facilitates alignment with statutory limits, reporting requirements, nondiscrimination testing, and participant tax filings.

A DCAP can be funded directly by the employer or with employee pre-tax salary reduction dollars under a cafeteria plan. In the latter case, the program is subject not only to the DCAP provisions but also to cafeteria plan rules. Within those parameters, employers have some flexibility to design the terms of a DCAP, including eligibility, benefits, and contribution limits.

Like other tax-advantaged employee benefits (e.g., self-insured group health plans, cafeteria plans, group term life insurance), a DCAP is subject to nondiscrimination provisions to prevent employers from designing plans that favor top earners (referred to as highly compensated employees (HCEs)) and to ensure that the tax exclusion is available only when the benefits are provided fairly across the workforce.

The IRS has not yet published implementing regulations or formal guidance explaining how the Section 129 nondiscrimination rules should be applied in practice, but the statutory requirements apply to all employers that offer DCAPs. While the statutory framework is relatively clear, practitioners often rely on analogous provisions and informal IRS commentary to support operational decisions. Employers and those implementing or administering the DCAP on their behalf should be familiar with both sets of nondiscrimination provisions.

This publication examines the DCAP nondiscrimination requirements, problematic plan designs, timing of testing, the definition of HCE, the types of tests that must be satisfied, the consequences of a discriminatory plan design, and the methods for correcting nondiscrimination failures. It includes a chart of IRS Limits on Retirement Benefits and Compensation, including the HCE thresholds for current and prior years (Appendix A, relevant for DCAP nondiscrimination testing), and a Sample Employee Communication for notifying HCEs of benefit election adjustments that may be required to satisfy nondiscrimination testing (Appendix B).

Note: Self-insured group health plans (including health reimbursement arrangements (HRAs)) and cafeteria plans (pre-tax contribution arrangements, including health FSAs) are subject to a different set of nondiscrimination rules, found in IRC Sections 105 and 125, respectively. For further information on those two sets of rules as well as a high level summary of nondiscrimination rules, see the PPI publications **Sections 105 and 125 Nondiscrimination Rules: A Guide for Employers** and **Nondiscrimination Rules: A Quick Reference Chart.** For further information about the application of Section 79 nondiscrimination rules to employer-provided group term life insurance – another popular employee benefit – see the PPI publication **Group Term Life Insurance: A Guide for Employers**.

TYPES OF PLANS SUBJECT TO NONDISCRIMINATION RULES

Section 129 applies to benefits received by employees through employer-sponsored DCAPs (including those funded with pre-tax salary reduction dollars). DCAP benefits include not only reimbursements from the DCAP itself, but also direct payments of dependent care expenses by employers and the fair market value of any on-site dependent care services that are not paid for by employees on an after-tax basis.

GENERAL REQUIREMENTS AND PROBLEMATIC PLAN DESIGNS

General Requirements

Section 129 contains four basic nondiscrimination tests (described in greater detail in the Details of Section 129 Nondiscrimination Tests section below):

- **An eligibility test.** The DCAP must benefit employees who qualify under an eligibility classification that does not discriminate in favor of HCEs.
- **A benefits and contributions test.** The benefits or contributions provided under the DCAP must not discriminate in favor of HCEs.
- **The "5% owner test."** Not more than 25% of the total benefits under the DCAP can be provided to individuals who own more than 5% of stock, capital, or profit interest of the employer company.
- **The "55% average benefits test."** The average benefits provided to non-HCEs must be at least 55% of the average benefits provided to HCEs.

Problematic Plan Designs

DCAPs that exclude certain categories of employees from participation (e.g., part-time, hourly, specific location) or that are only available to employees of one member employer of a controlled group may have difficulty satisfying the nondiscrimination testing requirements. In addition, because the 55% average benefits test is a utilization test, even DCAPs that are available to all employees on the same terms often struggle to pass nondiscrimination testing. See 55% Average Benefits Test below.

GENERAL CONCEPTS: CONTROLLED GROUPS AND TESTING TIMEFRAME

Controlled Groups (Companies Under Common Ownership)

Generally, the Section 129 nondiscrimination testing provisions apply on a per plan basis, and single employer plans are tested on their own. That said, the controlled group and affiliated service group rules under Section 414 apply, meaning employees of all commonly owned or affiliated employers must be aggregated when identifying HCEs and performing the tests. Employers should confer with legal counsel as needed to determine whether a group of companies is under common ownership.

When to Perform Nondiscrimination Testing

The rules do not prescribe a specific date or timeframe for performing nondiscrimination testing; they simply say that the DCAP must not be discriminatory. Thus, it is presumed that testing will occur at the end of the plan year.

PPI Observation	Although employers may choose to structure a DCAP on a non-calendar year basis, doing so introduces administrative complexities. Note that the DCAP exclusion and related reporting (Form W-2 for employers and Forms 1040 and 2441 for employees) are based on a participant's taxable year, which is typically the calendar year. Although Section 129 does not specify a required testing period, calendar year testing is generally considered a reasonable and practical approach, even for non-calendar year plans. Testing on a calendar year basis is generally most convenient for employers, as it aligns with the timing of Form W-2 reporting and provides a natural opportunity to review DCAP activity while year-end payroll processes are underway (and is before the end of the non-calendar plan year).

To help ensure that the plan will pass testing, a general best practice is to perform nondiscrimination testing shortly after open enrollment (prior to the start of the plan year for calendar year DCAPs) or early in the calendar year (for non-calendar year DCAPs). This gives employers ample time to determine whether additional steps must be taken before the end of the plan year.

Employers should also monitor and revisit the testing at least once during the plan year, particularly if there are significant changes in employee composition, such as new hires, reorganization, business acquisition, etc. In addition, employers should perform the tests (or confirm prior tests) at the end of the calendar year to confirm compliance by the last day of the plan year. Employers should note that the tests take into account all non-excludable employees who were employed on any day during the calendar year, including employees who are no longer active participants as of the testing date. Lastly, if the employer is involved in a business reorganization (such as a merger or acquisition), the testing should be reviewed as part of the reorganization process. For further discussion of nondiscrimination testing and other compliances concerns in the context of mergers and acquisitions, see the PPI publication Health Benefits Compliance Considerations in Mergers and Acquisitions: A Guide for Employers.

Definition of Highly Compensated Employee

Generally, status as an HCE for DCAP testing purposes is determined using the same definition of HCE that is used to identify HCEs for testing qualified retirement plans (e.g., 401(k) plans) for discrimination. Under Section 129, the definition of HCE includes a more-than-5% owner/shareholder and any employee with compensation in excess of the indexed threshold for HCEs (see Appendix A).

Section 129 explicitly directs employers to use the prior plan year's compensation amounts in determining whether an employee has compensation greater than the indexed threshold. (Note that the HCE definition relies on plan year compensation figures.) An employee is a more-than-5% owner/shareholder of the employer company for a particular year if at any time during that year the employee owns more than 5% of the value of the outstanding stock of the corporation or stock that represents more than 5% of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a more-than-5% owner/shareholder is any employee who owns more than 5% of the capital or profit interest of the employer company.

DETAILS OF SECTION 129 NONDISCRIMINATION TESTS

Nondiscrimination testing is required whenever an employer offers a DCAP, regardless of whether eligibility, contributions, or benefits vary among employees. While DCAPs can be offered on the same terms to all employees, the 55% average benefits test, which is a utilization test, leaves employers particularly vulnerable to nondiscrimination failures.

To be considered nondiscriminatory, a plan must satisfy four tests: the eligibility test, the benefits and contributions test, the 5% owner test, and the 55% average benefits test.

Eligibility Test

Under the eligibility test generally, a plan must not discriminate in favor of HCEs as to eligibility to participate. A plan that is offered on the same terms to all employees will satisfy this test. However, if the plan excludes certain employee groups from eligibility, it must be structured to benefit a classification of employees that meets the IRS's "reasonable classification" standard — meaning the classification is based on objective business criteria and does not favor HCEs.

Under the reasonable classification test, the IRS requires that any employee group excluded from a DCAP must be based on a reasonable classification that does not favor HCEs. While the IRS does not define "reasonable" in detail for Section 129, many practitioners rely on the two-part test used under Section 410(b) for retirement plans.

This test first looks at whether the classification is based on legitimate business criteria, such as job type, full-time versus part-time status, union membership, location, or hire date. Second, it evaluates whether the classification is nondiscriminatory using either a safe harbor percentage or a facts-and-circumstances analysis. Because this determination depends on an employer's particular set of facts and circumstances, employers should work closely with their testing vendors or legal counsel to ensure compliance.

With respect to the eligibility test, certain employees may be excluded when making the calculations. Excludable employees include:

- Employees covered by a collective bargaining agreement (if DCAP benefits have been a subject of good faith bargaining)
- Employees with less than one year of service
- Employees who have not attained age 21 as of the testing date

Note that employees who have not met the plan's service and age requirements may be excluded for testing purposes only if they are also excluded from participation in the plan.

Benefits and Contributions Test

With respect to the benefits and contributions test, both HCEs and non-HCEs must generally be provided with the same benefits. That is, DCAP benefits and contributions must not favor HCEs. This is generally a facts-and-circumstances analysis that considers whether HCEs receive different or greater benefits – or pay less for the same benefits – than others. There is no quantitative test for determining whether this requirement is satisfied. Practically speaking, the majority of DCAPs are funded solely through employee salary reduction and are provided on the same terms to all eligible employees (or limits are imposed only on the amounts that HCEs can contribute to pass the 55% average benefits test). For this reason, most DCAPs will automatically satisfy the benefits and contributions test. However, if one member of a controlled group makes separate employer contributions to its DCAP (e.g., "seed" money, matching contributions, or employer-paid on-site dependent care services) and others do not, the plan could potentially fail this test.

5% Owner Test

In contrast to the eligibility and benefits/contributions tests, the 5% owner test is a utilization test: it looks at actual DCAP benefits paid to owners and shareholders versus non-owners. At a high level, the test is meant to confirm that principal owners and shareholders of the employer are not disproportionately receiving DCAP benefits. To satisfy this test, not more than 25% of the amounts paid or incurred by the employer for DCAP benefits during the year may be provided to 5% owners of the employer. Practically speaking, most plans satisfy the 5% owner test because owners generally don't participate in a DCAP (most owners are considered self-employed and are therefore unable to participate in a Section 125 pre-tax contribution DCAP) or because they don't participate to a level of receiving 25% or more of the DCAP benefits.

55% Average Benefits Test

Similar to the 5% owner test, the 55% average benefits test is a utilization test that looks at actual DCAP benefits paid out. Specifically, under this test, the average DCAP benefits provided to non-HCEs must be at least 55% of the average benefits provided to HCEs. Thus, on average, for every $100 reimbursed to HCEs, at least $55 in benefits must be reimbursed to non-HCEs.

PPI Observation	For purposes of the 55% average benefits test, the law does not specifically address how to treat forfeitures, meaning any unused DCAP amounts remaining at the end of the plan year or after an employee terminates. When a DCAP is offered through a Section 125 cafeteria plan, "benefits provided" are generally interpreted to mean the reimbursements employees actually receive, rather than the amounts they elected to contribute. Under this interpretation, forfeited amounts would not be included in the nondiscrimination testing. This interpretation, however, may be difficult to apply in practice. If a plan allows employees to submit claims during a run-out period (after the plan year ends), the amount of forfeitures may not be known when testing is conducted (e.g., either before the end of the plan year or sometime before the end of the run-out period). Given this uncertainty and the absence of clear IRS guidance, some employers take a conservative approach and treat all elected amounts as "benefits provided" for testing purposes. Employers should review concerns with their testing vendor and legal counsel.

55% Average Benefits Test Example

Employer XYZ has seven employees — A, B, C, D, E, F, and G. A and B are HCEs; C, D, E, F, and G are non-HCEs. All employees are eligible to participate in XYZ's DCAP as of their date of hire. A, B, C, and D participate in the DCAP through the cafeteria plan, using salary reduction agreements, but E, F, and G do not participate in the DCAP at all. A, B, C, and D have each reduced their salaries by $5,000 and are each provided benefits worth $5,000 under the plan (i.e., there are no forfeitures).

In running the 55% average benefits test, XYZ must compare the average benefits of the HCEs with those of the non-HCEs. The average benefit provided to the HCEs is $5,000 [($5,000 + $5,000) ÷ 2]. The average benefit provided to the non-HCEs is $2,000 [($5,000 + $5,000 + $0 + $0 + $0) ÷ 5]. The average benefit provided to the non-HCEs is 40% of the average benefit provided to the HCEs ($2,000 ÷ $5,000 = 0.4). Consequently, the DCAP fails the 55% average benefits test.

METHODS FOR AVOIDING AND/OR CORRECTING NONDISCRIMINATION FAILURES

Because HCEs typically participate in DCAPs at much higher rates than non-HCEs, it is common for DCAP plans to fail nondiscrimination testing, particularly the 55% average benefits test.

PPI Observation	Non-HCE participation in DCAPs tends to be low, often due to concerns about forfeiting unused funds and the upfront cost of dependent care. Many non-HCEs are hesitant to participate because they worry about inaccurately estimating future care expenses and losing pre-tax contributions under the "use-itor-lose-it" rule. Lower-paid employees might also find it difficult to set aside pre-tax dollars for future reimbursement. In many childcare arrangements, families must pay for care in advance, but DCAP reimbursement can only be made after the care has been provided. This delay between payment and reimbursement creates a cash flow barrier for lower-paid employees, making the benefit less accessible and contributing to nondiscrimination testing challenges.

To reduce or avoid the likelihood of failure, employers may consider completely excluding HCEs from participating in the DCAP. A less restrictive approach is to cap HCE DCAP elections during open enrollment, before the plan year starts. Yet another approach is to cap HCE elections after tests are conducted during the plan year. Employers can also take general steps to increase and improve plan communications to help non-HCEs understand the value of DCAP participation. In addition, employers can offer matching contributions (or seed money) to non-HCEs who participate in the DCAP.

As far as correcting nondiscrimination failures, the cafeteria plan or the DCAP plan document should provide for a reduction or discontinuation of participants' salary reductions as needed to comply with the nondiscrimination provisions. Plan documents that include this provision allow plan administrators to cut back HCE salary reductions into the DCAP, thereby preserving the exclusion for all participants. Another possible (if aggressive) practice is to re-characterize a portion of the HCE DCAP benefits as taxable (i.e., by imputing income and withholding applicable income and employment taxes) to the extent necessary for the DCAP to pass the applicable test. An employer that takes this approach might re-characterize an equal percentage of each HCE's benefits or use a "bubble-down" approach under which re-characterizations are made beginning with the HCEs whose benefits are greatest. So long as this is done before the close of the calendar year, such a correction would place a participant in a similar position to that of a prospective cutback in their DCAP salary reductions. For a discussion of informal election change events that include nondiscrimination failures, see the PPI publication **Midyear Election Change Events: A Guide and Matrix for Employers**.

Overall, employers must consider the advantages and disadvantages of each approach to avoiding or correcting nondiscrimination failures. If an employer expects to fail the tests or has capped the DCAP elections of HCEs, tests should be conducted as early in the year as practical, and the employer should clearly communicate any salary reduction changes to HCEs whose DCAP elections must be adjusted to satisfy nondiscrimination testing (see Sample Employee Communication in Appendix B).

CONSEQUENCES OF A DISCRIMINATORY DCAP PLAN DESIGN

Under Section 129, a discriminatory plan design (i.e., one that fails any one or more of the four DCAP nondiscrimination tests) results in adverse tax consequences for HCEs. Specifically, HCEs lose the applicable tax exclusion and have the value of the benefit included in their income; that is, their DCAP reimbursements become taxable.

Importantly, non-HCEs are not affected by a discriminatory plan design; they still qualify for all of the tax advantages associated with the DCAP. In addition, there are no additional monetary penalties for employers providing a discriminatory plan, but discriminatory amounts included in income for the particular employee may be subject to employment taxes (in addition to income taxes). It is important for employers to consult with their tax experts to determine the appropriate amount of income and tax reported and whether Forms W-2 need to be amended.

SUMMARY

To preserve the tax advantages for all DCAP participants, employers must ensure the plan does not discriminate in favor of HCEs. This requires identifying HCEs and applying all four statutory nondiscrimination tests under Section 129: the eligibility test, the benefits/contributions test, the 5% owner test, and the 55% average benefits test.

Among these, the 55% average benefits test presents particular challenges, as it measures actual benefit utilization and is often affected by low participation rates among non-HCEs. Additionally, all entities within a controlled group must be included for testing purposes.

Although the statute does not expressly permit corrective action, the IRS has informally indicated that adjustments (such as reducing HCE elections) may be acceptable if made before the end of the tax year. Employers are encouraged to test early and consult with legal counsel or third-party administrators to address any issues proactively.

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APPENDIX A

IRS Limits on Retirement Benefits and Compensation

	2026	2025	2024
401(k) and 403(b) plan elective deferrals	$24,500	$23,500	$23,000
Catch-up contributions (age 50 and older)	$8,000*	$7,500*	$7,500
Annual compensation limit	$360,000	$350,000	$345,000
Highly compensated employee threshold**	$160,000	$160,000	$155,000
Key employee compensation threshold**	$235,000	$230,000	$220,000
Defined contribution plan limit under Section 415	$72,000	$70,000	$69,000
Defined benefit plan limit under Section 415	$290,000	$280,000	$275,000
SIMPLE employee contribution limit	$17,000	$16,500	$16,000

See **www.irs.gov** for more information.

*Individuals who attain age 60, 61, 62, or 63 in 2025 can make catch-up contributions up to $11,250 in 2025 and 2026.

**In general, compensation means total compensation from the employer, including bonuses or commissions as well as contributions made through a 401(k) plan (or similar retirement plan) or through a cafeteria plan or qualified transportation benefit plan.

The chart above is excerpted from the PPI publication **Employee Benefits Annual Limits**. See that publication for other annual limits that affect group health plans.

APPENDIX B

Sample Employee Communication

To: [Personalized Name of Affected HCE Plan Participant]

Subject: Nondiscrimination Testing for [Name of Benefit Plan] for Plan Year [YYYY]

In order for [Name of Company] to pass nondiscrimination testing for the above-referenced benefit plan, we are required from time to time to take corrective measures that include reducing the pre-tax benefit plan contributions of highly compensated employees. This action allows us to maintain the plan's favorable tax status and safe harbor provisions.

Based on the most recent nondiscrimination tests, we have determined that we must reduce your benefit plan election for the referenced plan year as follows:

[Insert details of original and revised plan year election amounts]

If you have already contributed more than the revised plan year amount as of the date of this notice, the excess amount will be returned to you as taxable income as soon as administratively practicable.

Please contact the Human Resources department at [HR email contact] if you have any questions.

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