IRS Proposes Long-Awaited Nondiscrimination Testing Rules for Dependent Care Assistance Programs

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Proposed regulations issued by the Department of the Treasury and Internal Revenue Service on Aug. 11, 2026, address dependent care assistance programs (DCAPs), providing long-awaited guidance on the nondiscrimination requirements applicable to existing DCAPs under Section 129.

DCAPs allow employers to provide tax-favored benefits to help employees pay for qualifying dependent care expenses. To receive favorable tax treatment, these programs are subject to nondiscrimination rules designed to prevent the benefit from disproportionately favoring highly compensated employees (HCEs). The new proposed regulations provide substantially more detail about how employers should conduct those tests.

What did the Agencies Clarify?

Eligibility Tests

The proposed rules provide a framework for determining whether the group of employees eligible for a dependent care program is nondiscriminatory. An eligibility classification generally must be reasonable and based on objective business criteria and must satisfy either a facts-and-circumstances standard or a numerical safe harbor.

The numerical safe harbor is based on the ratio of eligible non-highly compensated employees (NHCEs) to eligible HCEs. If the ratio meets or exceeds the safe harbor threshold (which starts at 90% and decreases with greater NHCE concentration), the numerical safe harbor is met.

If a company fails to meet the numerical safe harbor, the IRS uses a facts-and-circumstances test that considers whether eligibility is based on reasonable business classifications – such as job category, compensation method, or geographic location – and evaluates factors including the business rationale, workforce representation, and how close the plan comes to satisfying the numerical safe harbor.

The proposed rules also clarify that certain employees may be disregarded for purposes of the eligibility and average-benefits tests. These include certain employees under age 21, employees who have not completed one year of service, and certain collectively bargained employees.

Under the average-benefits test, the average benefit provided to NHCEs must be at least 55% of the average benefit provided to HCEs. Under the proposed regulations, the test would calculate the average benefit using employees who actually receive a benefit greater than $0 (participating employees), with testing performed as of the last day of the plan year.

Plan Correction After Failure

The proposed regulations create a formal correction for DCAPs. Under the proposed regulations, if discrimination testing fails, the company may address the failure by including the excess benefit amounts in the income of HCEs and reporting the income by the W-2 deadline.

Action Items for Employers

- Consider public comment. Employers wishing to provide public comment on the proposed regulations must do so by Sept. 25, 2026.
- Review current testing methodology. Employers that sponsor a DCAP should compare their existing nondiscrimination testing practices with the methodology described in the proposal.
- Pay particular attention to participation data. Because the proposed average-benefits calculation focuses on employees who actually receive benefits, employee elections and utilization could materially affect testing results.
- Test before year-end. Employers should consider preliminary testing before the end of the plan year so that potential problems involving highly compensated employees can be identified and corrected prior to W-2 reporting deadlines.
- Coordinate with administrators and testing vendors. Confirm that outside administrators or nondiscrimination-testing vendors understand the proposed eligibility classifications, 55% average-benefits calculation, permissible exclusions, and correction framework.

Although the regulations are still proposed, they provide employers with the most detailed framework to date for administering Section 129 nondiscrimination testing. Employers with existing dependent care programs should use the guidance as an opportunity to review testing procedures rather than waiting until the regulations become final.