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New Proposed IRS Regulations Expand Benefits Available to Highly Compensated Employees Under Dependent Care Assistance Plans

November is typically when companies have open enrollment for their benefit plans for the upcoming calendar year.

This summer, employers received a nice surprise when the Internal Revenue Service ("IRS") issued proposed regulations for dependent care assistance plans ("DCAPs"), which clarified an issue that had bedeviled employers since 1981, when Congress added section 129 to the Internal Revenue Code to provide tax-favored treatment for DCAPs.

As explained below, the guidance in these regulations may have significant implications for employers who maintain DCAPs.

DCAP NONDISCRIMINATION TESTING

DCAPs are plans that typically are structured to permit employees to make salary-reduction contributions, which are returned in the form of tax-free reimbursements or payments for qualifying dependent care expenses. In addition to annual statutory benefit limits ($7,500 in 2026), DCAPs must satisfy four nondiscrimination tests: (1) a contributions and benefits test, (2) an eligibility test, (3) a test limiting benefits for more-than-5 percent owners to 25 percent of a plan's annual benefits, and (4) a test which requires a plan's annual average benefits for non-highly compensated employees ("NHCEs") to be at least 55 percent of the average benefits of highly compensated employees ("HCEs"). The terms "NHCE" and "HCE" have the same definitions as those terms have under the 401(k) plan nondiscrimination testing rules.

The issuance of these regulations was prompted by a provision in the 2025 One Big Beautiful Bill Act legislation that created Trump Accounts. Employer-sponsored Trump Account contribution programs must satisfy nondiscrimination requirements akin to those applicable to DCAPs.

WHAT THE DCAP PROPOSED REGULATIONS DID

Before the proposed regulations, a point of uncertainty had been how the 55 percent average benefits test is supposed to work. The average benefits for the HCEs and the NHCEs are the total annual benefits payable to each group, divided by the number of employees in each group.

What was unclear before the proposed rules was how the denominator was to be calculated.

Consider the following example:

- A regional accounting firm, which has a DCAP, has 200 employees, ignoring those employees whom the statute says an employer can exclude from the test.
- 50 of those employees are HCEs and 150 are NHCEs.
- The 2025 total DCAP benefits paid to the HCEs was $20,000.
- The 2025 total DCAP benefits paid to the NHCEs was also $20,000.

In the absence of IRS guidance, many employers had used as the divisor, for calculating the HCE and NHCE average benefits, the number of non-excluded employees. On that basis, the HCE average benefit would be $400 ($20,000 ÷ 50) and the NHCE average benefit would be $133.33 ($20,000 ÷ 150). Because $133.33 is less than 55 percent of $400, the accounting firm's DCAP would fail the average benefits test; and the HCEs would be taxed on their DCAP reimbursements.

But the proposed regulations count only those employees in each group **who actually make contributions**, which produces a much more favorable outcome for HCEs.

If in the accounting firm example, only 10 HCEs and 15 NHCEs actually had made DCAP contributions, the average benefit for each group would be $2,000 ($20,000 ÷ 10) for the HCEs and $1,333.33 ($20,000 ÷ 15) for the NHCEs, and the plan would pass the average benefits test.

WHAT THIS MEANS FOR COMPANIES WITH DCAPS

In the face of the average benefit uncertainty, many (if not most) employers have capped the DCAP contributions of HCEs. The proposed regulations, which the IRS has said employers may rely upon now, are likely in many instances to substantially increase the tax benefits that HCEs can obtain under DCAPs. Accordingly, before open enrollment commences for 2027 benefits, employers should look at whether they can loosen, or drop altogether, their caps on HCE contributions.

For more information or assistance, please contact Daniel L. Morgan, or another member of the Benefits & Executive Compensation group.

Daniel L. Morgan
202.420.4779 | dan.morgan@blankrome.com

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