Dependent Care Assistance Plan (DCAP) Basics

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§129 of the tax code permits employees to exclude up to $5,000 ($7,500 beginning in 2026) per calendar year from gross income to pay for dependent care expenses. These arrangements, required to be established by a written document, are referred to as Dependent Care Assistance Programs (DCAPs). In many ways they function similarly to health flexible spending accounts (FSAs), so they are frequently referred to as dependent care FSAs. This summary discusses the various rules to be aware of when implementing and administering a DCAP.

Participation

From a tax perspective, any common-law employee of the employer can participate in the employer's DCAP, subject to the employer's eligibility rules. Employers often limit eligibility to participate in a DCAP to full-time employees. If employers include part-time employees as eligible, part-time employees should also be made eligible for the employer's cafeteria plan so that they can make contributions through pre-tax salary reductions.

In addition, self-employed individuals are technically able to participate in a DCAP, but they are not permitted to participate in an employer's §125 cafeteria plan. In other words, self-employed individuals (e.g., sole proprietors, partners and >2% S-Corp shareholders) can receive employer contributions to a DCAP but cannot make pre-tax contributions to a DCAP. Permitting self-employed individuals to participate in a DCAP with employees who are eligible to contribute on a pre-tax basis requires that the separate funding methods be explained in the document that establishes the DCAP.

Contributions

DCAPs allow either the employer or the employee to contribute funds to reimburse dependent care expenses on a tax-favored basis. Regardless of who makes the contributions, the annual reimbursement amount for 2025 and prior years is limited to the lesser of: (i) $5,000 for single individuals or married individuals filing joint tax returns ($2,500 for married individuals filing separately); and (ii) the earned income of the employee/spouse.

§125 requires all employee contributions to be made on a uniform basis. Therefore, in most cases DCAP contributions are made ratably (equal contributions) throughout the plan year. Employees can begin making DCAP contributions before they have any eligible expenses. For example, a person who anticipates having to make childcare payments later in the year due to the birth of a child may elect to begin contributing to a DCAP at the beginning of the year.

Calendar Year Limit

The limit always applies on a calendar year basis, even for non-calendar year plans. Because the reimbursement limit is always calculated on a calendar year basis, it may be easier (but not required) for employers to offer the DCAP on a calendar basis. In addition, to help employees ensure that the reimbursement limit is not exceeded, some employers choose to pro-rate the annual contribution limit for employees who join mid-plan year.

Family Limit

In addition, the limit applies on a family basis. If both spouses have the opportunity to participate in DCAPs, or if an employee participates in DCAPs under separate employers within the same calendar year, the spouses together cannot receive more than the annual limit in tax-favored reimbursement for the calendar year.

Examples

Example 1

Andrea switches jobs mid-year. Under her previous employer, she participated in a DCAP and contributed a total of $2,400 to the plan during the first part of 2025. She joins her new employer's DCAP and may contribute an additional $2,600 to the DCAP for the remainder of the 2025 calendar year.

Example 2

Same facts as Example 1, except that Andrea did not contribute to a DCAP with her previous employer. Andrea may elect the full $5,000 to contribute to her DCAP with her new employer for the remainder of the 2025 calendar year if the employer doesn't limit contributions on a pro rata basis tied to the number of months remaining in the plan year.

Example 3

Same facts as Example 2, except that Andrea's spouse (with whom she files jointly) also participates in a DCAP and has contributed $3,000 to that DCAP for the 2025 calendar year. When Andrea joins her new employer's DCAP, she may contribute up to $2,000 for the remainder of the 2025 calendar year only if her spouse does not contribute any additional amounts to a DCAP.

Limit Changes Beginning in 2026

Beginning January 1, 2026, the annual reimbursement limit for DCAPs will increase for the first time in decades. Employees will be able to contribute up to $7,500 per year on a tax-free basis for qualified dependent care expenses, up from the current $5,000 limit. For those who are married and file separately, the new limit will be $3,750. It's important to note that the new limits are not indexed for inflation, so they will remain fixed unless future legislation is enacted.

Employers are not required to increase the annual contribution/reimbursement limits, but we expect that many will choose to do so. To offer the ability to contribute up to $7,500 beginning in 2026, employers must amend their plan documents and update payroll and benefit systems accordingly. NOTE:

Increasing the reimbursement limit to $7,500 could make it even more difficult for employers to pass applicable discrimination testing if it is primarily highly compensated employees who participate and elect the full $7,500.

The higher limit applies for the 2026 calendar year, even for employees participating in a non-calendar year DCAP. For employers with a calendar year plan, this will be an easy transition; employees can be given the option during the 2026 open enrollment to increase elections up to $7,500 for the 2026 plan year. For employers with a non-calendar year DCAP, the transition may be a little trickier. There are different options for employers wanting to increase the contribution limit with a non-calendar year DCAP.

<table>
<tr><th colspan="2">2026 Contribution Options for Non-Calendar Year Plans</th></tr>
<tr><td>OPTION 1</td><td>The employer could wait to make any changes until the 2026 plan year renewal. For example, if the employer has an October - September plan year, the employer could leave the contribution limit at $5,000 through September 2026 and then increase the contribution limit beginning with the October 2026 - September 2027 plan year.</td></tr>
<tr><td>OPTION 2</td><td>The employer could adjust the contribution limit January 1, 2026 and doing so would permit a mid-year election change for DCAP participants as of January 1. Using an October - September plan year as an example:
• The employer could allow an additional $7,500 to be contributed Jan - Sept 2026 beyond what was already Oct - Dec 2025.
○ For example, for those who elected $5,000 and contributed $416.66/month for Oct – Dec 2025 ($1,250 total), the employer could allow them to increase their 2025-2026 election by $3,750 (allowing employees to contribute the remainder of the previously elected $3,750 plus an additional $3,750 to hit $7,500 for 2026).
○ However, then the employees would not be able to contribute anything more for the remainder of 2026 after the 2025-2026 plan year ends.
• Most employers will limit the monthly contribution amount to $625/month ($7,500/12) for the remainder of the 2025-2026 plan year.
○ For example, for those who elected $5,000 in October 2025 (and contributed $1,250 for Oct – Dec 2025) they could increase their election by $1,875 for the remainder of the 2025-2026 plan year (or $6,875 total for the 2025-2026 plan year). The increase is an additional $208.33 x 9 months, allowing contributions of $625/month for Jan – Sept 2025 (previously elected $416.66/month + additional $208.33/month).
○ Employees would then be able to elect up to $7,500 for the subsequent plan year as well.</td></tr>
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Mid-Year Changes

§125 requires employees to decide at the beginning of the coverage period what they are going to contribute over the duration of the coverage period (plan year) and permits election changes only upon the occurrence of certain events. However, in contrast to other benefits that can be offered under a §125 cafeteria plan, DCAP election changes are more flexible. The permitted election change events that apply to DCAPs fall into the following broad categories:

- Change in status. Various changes in status (e.g., marriage, birth/adoption, change in employment status) may affect the eligibility of dependent care expenses.
- Change in cost and coverage. Certain changes in cost and coverage of the DCAP will justify a midyear change in election. For example, when there is a change in the cost of a dependent care provider, or when a participant changes dependent care providers, a plan usually can permit a midyear change in election.
- FMLA. Employees who take FMLA leave are entitled to revoke elections of non-health benefits (such as a DCAP) under a cafeteria plan to the same extent as employees taking non-FMLA leave. And certain reinstatement rules apply upon return from FMLA leave.

The flexibility for DCAP changes mid-plan year is best illustrated by the examples found in §1.125-4(f)(6). Under DCAP election change rules, a change in work schedule, change in provider or provider availability, change in school schedule, etc. would all likely permit a mid-year election change.

Eligible Expenses

To benefit from a DCAP, an employee must be eligible to participate and have eligible expenses to submit for reimbursement. Eligible expenses are for the care of a qualifying individual. That care must enable the employee, as well as the employee's spouse, to be gainfully employed. In addition, the expense cannot also be claimed under the Dependent Care Tax Credit. In 2026, the dependent care tax credit increases from 35% to 50%, but the qualifying dependent care expense cap remains at $3,000 for 1 child / $6,000 for more than 1 child.

Unlike health FSAs, DCAPs are not subject to the uniform coverage rule, so an employee has access only to what they have already contributed to the DCAP for reimbursement.

Qualifying Individual

An employee is permitted to submit care expenses under a DCAP only for "qualifying individuals."

Code §21(b)(1) defines the following as "qualifying individuals":

1. A dependent of the taxpayer who has not attained age 13;
2. A dependent of the taxpayer who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of such taxable year; or
3. The spouse of the taxpayer, if the spouse is physically or mentally incapable of self-care and has the same principal place of abode as the taxpayer for more than one-half of such taxable year.

Qualifying individuals can include individuals beyond the employees' children. However, in all cases, the individual must have the same principal place of abode as the employee for more than one-half of the taxable year for which the employee is attempting to use the DCAP. Special rules apply in the case of parents who are not married because the child will be a qualifying individual for only one of the parents (assuming the child is a qualifying individual for either).

Gainfully Employed

Care expenses are eligible for reimbursement only if the care enables the employee and the employee's spouse to be gainfully employed or in active search of gainful employment. Care acquired for personal reasons is not considered care that enables an employee and their spouse to be gainfully employed. For example, an employee would not be permitted to submit for DCAP reimbursement babysitter expenses incurred while the employee goes out to eat with their spouse.

Both the employee and the employee's spouse must be gainfully employed or actively searching for gainful employment to have any eligible DCAP expenses. For these purposes, both full-time and part-time employment can result in eligible DCAP expenses. Employees working part-time are permitted to submit care expenses only for working days. However, if an employee is required to pay for a period that includes non-working days, the employee can submit the entire expense for reimbursement. There is little guidance regarding what expenses will be reimbursed in the case of an employee or spouse actively searching for gainful employment. These expenses should be evaluated on a case-by-case basis.

Eligible Care Arrangement

Expenses are eligible for reimbursement only if the primary purpose of the expense is to assure the individual's well-being and protection. Therefore, expenses for educational programs, such as tutoring, music lessons, or other similar programs, are generally not reimbursable even if the employee would have had to procure other care had it not been for the educational program. There is a limited exception to this rule for certain summer day camps.

Several different types of care arrangements can be submitted for reimbursement under a DCAP. These care arrangements include daycare centers, in-home care (such as a nanny or au pair), custodial care, and, in some cases, backup/emergency care. If the care is provided by a tax dependent of the employee, the employee's child under the age of 19, the employee's spouse, or the qualifying individual's other parent who is not the employee's spouse, then the expense is not eligible for reimbursement.

Use-Or-Lose

Contributions are either used for reimbursement of care for qualifying individuals during the coverage period or forfeited (referred to as the use-or-lose rule). Plans may allow a 2½-month grace period during which employees may still incur expenses and submit claims to the DCAP. But unlike health FSAs, DCAPs are not permitted to allow for a carryover of unused amounts from one plan year to the next. In addition, a DCAP may be designed with a spend-down provision to permit individuals who are no longer participants to spend down their contributions through the end of the current plan year if they still have eligible expenses.

Reporting

Employers should report DCAP reimbursements for the calendar year in Box 10 on employees' Forms W-2. IRS guidance suggests the full cash reimbursement available to the employee for the calendar year (i.e., all employer and employee contributions) can generally be reported in Box 10, even if the employee has not received the full amount as reimbursements by the time the employer completes the Form W-2.

Nondiscrimination

Similar to other benefit nondiscrimination rules, nondiscrimination rules for DCAPs restrict the ability to favor highly compensated individuals or key employees on a tax-favored basis. A DCAP is subject to §129 nondiscrimination rules on its own as well as §125 nondiscrimination rules if the DCAP is offered through the employer's cafeteria plan (which is often the case). For this purpose, highly compensated individuals generally include officers, >5% shareholders and employees with annual compensation of $155,000 or more in the previous calendar year (for 2025).

Discrimination testing can be performed to determine whether the DCAP complies with applicable nondiscrimination rules. If the plan fails discrimination testing, corrections can be made prior to the end of the plan year to avoid potential adverse tax consequences for highly compensated or key employees. For example, the employer may have to take one or more of the following actions to reduce the amount available on a tax-favored basis to highly compensated or key employees:

- Limit further contributions for the remainder of the plan year;
- Include already reimbursed amounts in employees' taxable income; and/or
- Return already contributed amounts as taxable income.

In addition, for plans that struggle to pass discrimination testing, the following options may make sense for future plan years:

- Exclude highly compensated employees from eligibility;
- Set lower election caps for highly compensated employees at the beginning of the year; or
- Allow highly compensated employees to elect up to the maximum allowed for other plan participants and then adjust mid-plan year if discrimination testing is run and fails. It is best for this possibility to be included in plan language and communicated to highly compensated employees. The employer could then cut-off any additional salary reductions or re-characterize such reductions as taxable compensation when necessary to comply with applicable nondiscrimination rules.

Benefit nondiscrimination rules are enforced by the IRS. Failure to comply risks the highly compensated and key employees being taxed on benefits provided under the discriminatory plan. A failure to comply with the applicable nondiscrimination rules will not disqualify the entire plan or affect non-highly compensated employees; the additional income tax and any associated late penalties would affect only highly compensated and key employees (and the employer may then owe additional payroll taxes).

NOTE: The increase in the reimbursement limit to $7,500 beginning in 2026 could make it harder for DCAPs to pass applicable discrimination tests, especially the 55% average benefits test, which is commonly failed today.