Compliance Alert

IRS Updates Highly Compensated and Key Employee Thresholds for 2026

PROVANT

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IRS Indexes Highly Compensated and Key Employee Thresholds

The IRS issued Notice 2025-67 to announce updated limits reflecting retirement plan indexing. These updates include thresholds used to identify highly compensated employees under Internal Revenue Code Section 414(q) and key employees under §416(i), which are used for annually required non-discrimination testing for both retirement and several non-retirement benefit plans.

Applies To:

- All size employers allowing employees to make pre-tax paycheck deductions under a §125 plan *(except for a Simple Cafeteria Plan exempt from non-discrimination testing)*
- All size employers sponsoring a dependent care assistance program (DCAP) subject to §129
- All size employers sponsoring group term life insurance subject to §79
- All size employers sponsoring other arrangements that test discrimination against a §414(q) definition, including but not limited to §127(a) education assistance

Go Deeper:

2026 indexing is now complete for employee benefit plans. Several employee benefits require annual testing under various sections of the Internal Revenue Code (IRC) to ensure benefits do not overly favor highly compensated or key employees. Some highly compensated or key employee definitions rely on individuals exceeding certain income thresholds which are indexed annually.

- One **highly compensated** definition used in non-discrimination testing is found in IRC §414(q)(1)(B). It looks back at last year's income to determine if someone is highly compensated for the current year.
- One **key employee** definition used in non-discrimination testing is found in IRC §416(i)(1)(A)(i). It looks back at last year's income to determine if someone is a key employee for the current year.
- In both cases, a new hire will not have income from the prior year so the projected annual income is evaluated instead.

Common Benefits Subject to Non-Discrimination Testing

The most common benefit employers sponsor is a §125 Plan that allows employees to make pre-tax paycheck deductions for qualified health and welfare benefits. These plans are

WHAT'S NEW

- IRS Notice 2025-67 updates income thresholds for Highly Compensated Employees (§414(q)) and Key Employees (§416(i)), completing 2026 indexing for employee benefit plans.
- The HCE threshold increases to **$160,000** for 2025 and 2026, and the Key Employee officer threshold rises to **$230,000 in 2025** and **$235,000 in 2026.**
- These updated definitions impact annual non-discrimination testing for §125 cafeteria plans, DCAPs, FSAs, group term life, education assistance, and other benefits tied to §414(q) and §416(i).

TAKEAWAY

Updated IRS thresholds may shift which employees qualify as highly compensated or key employees, making it essential for employers to review plan eligibility, run timely non-discrimination testing, and adjust 2026 planning accordingly.

subject to annual non-discrimination testing with a couple of exceptions:

- A §125 Plan that only allows employees to make pre-tax paycheck deductions for premiums and not for account-based plans like FSA, DCAP, or HSA, can typically pass just the safe harbor percentage component of the eligibility test and avoid running the rest of the §125 tests.
- A Simple Cafeteria Plan has such strict requirements for small employers to meet that it avoids the need to run non-discrimination testing.

Other common benefits which run annual non-discrimination testing include FSA, DCAP, group term life, and education assistance. The table below provides a description of where definitions of highly compensated or key employees are utilized:

	2025	2026	2027
§125 Plan pre-tax paycheck deductions			
Highly compensated individual (HCI)	$155K in 2024	$160K in 2025	$160K in 2026
Other HCIs (officers, more-than-5% owner current or preceding year, and employed spouses and dependents of HCIs)	No income test	No income test	No income test
Key employee officer	$220K in 2024	$230K in 2025	$235K in 2026
Key employee more-than-1% owner	$150K	$150K	$150K
Key employee more-than-5% owner current or preceding year	No income test	No income test	No income test
§129 DCAPs			
Highly compensated employee (HCE)	$155K in 2024	$160K in 2025	$160K in 2026
Other HCEs (more-than-5% owner current or preceding year, and employed spouses and dependents of HCEs)	No income test	No income test	No income test
§79 Group term life insurance			
Key employee officer	$220K in 2024	$230K in 2025	$235K in 2026
Key employee more-than-1% owner	$150K	$150K	$150K
Key employee more-than-5% owner current or preceding year	No income test	No income test	No income test
§127(a) Education assistance			
Highly compensated employee (HCE)	$155K in 2024	$160K in 2025	$160K in 2026

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Note that some employers have enough highly compensated employees that they consider whether to exercise the top 20% paid group election to make it a smaller group of HCIs. Doing this requires amending each impacted plan (including the §125 Plan) and any qualified retirement plan, as it is a universal election they commit to in writing for the year for both retirement and non-retirement benefits that rely on a §414(q) compensation threshold.

Employer Considerations:

Non-discrimination testing is required annually of almost every employer sponsoring employee benefits. Employers with an FSA or DCAP administrator will often rely on that administrator to run their annual testing, but there are other third party administrators that can help if needed, including COBRA or 5500 filing administrators.

A DCAP in particular needs to run preliminary testing early in the year, usually by April, to ensure it appears as though it might pass testing at the end of the year. If preliminary testing indicates an imbalance, the employer will want to reach out to highly compensated employees with large DCAP elections to lower election amounts that make it more likely for the employer to pass testing at the end of the year.

Submitting test results to the IRS is not required, but they must be kept on file and provided in an audit to demonstrate the plans did not overly favor highly compensated or key employees. These tests are also requested in due diligence audits for a merger or acquisition.

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