Federal & State Tax Implications of Kentucky's New Employee Child Care Assistance Partnership Program

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Authors:

Patrick W. Thomas
Jennifer Y. Barber

Governor Andy Beshear signed House Bill 499 into law in April 2022, thereby creating a new program called the Employee Child Care Assistance Partnership (ECCAP).[1] The program went into effect on July 1, 2023, and now allows the Commonwealth to match financial contributions that an employer makes to assist an employee with childcare expenses, through funding from the Kentucky Cabinet for Health and Family Services.[2] This private-public partnership is intended to address the affordability of childcare within Kentucky, a major hurdle to workforce participation and struggle for many Kentuckians.

For example, if an employer provides $100 per month to assist an employee with childcare costs, the state will match that with another $100. This would result in $200 in assistance for the eligible employee. $15,000,000 in funding for the program was included in Kentucky's next two-year budget, with 25% of that set aside specifically for use by small businesses.[3]

Various restrictions apply, and all payments are made directly to eligible childcare providers—not to the employees themselves.[4] The details of the ECCAP are outlined in the newly created KRS Chapter 199.[5] Nonprofit and for-profit employers of any size may participate in the partnership and must opt in via an application process, which must be renewed annually beginning in 2024.[6] Applications are available online on the Kynect website.

The state match is limited based on an employee's household income, as compared to the state median household income. For anyone at or below 100% of the state's median household income, the employer contribution will be matched at 100%. Anything at or above 180% of the state's median household income will be matched at 50%, subject to a total household income cap of $139,860.[7]

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Employers are curious as to the tax implications of this new program and how to continue satisfying federal, state, and local tax requirements when implementing ECCAP. The remainder of this post explores the tax implications of existing childcare benefits and how they relate to the new ECCAP program.

Federal, State, and Local Tax Implications of Childcare Benefits

First, ECCAP must be situated within the current framework of other employer-provided childcare tax benefits. Employers may already provide childcare benefits for employees via Dependent Care Assistance Programs (DCAPs), or they may take advantage of the Employer-Provided Child Care Credit.

DCAPs are outlined in Section 129 of the Internal Revenue Code. They provide tax-free benefits for an employee for amounts paid or incurred by the employer for dependent care assistance benefits provided to the employee. This allows employers to exclude up to $5,000 in qualifying childcare benefits from an employee's wages per tax year, or $2,500 if married and filing separately.[8] Kentucky conforms to this provision of the Internal Revenue Code, meaning the exclusion also applies to state income taxes.[9]

Dependent Care FSA programs are a method of funding DCAPs that allow employees to have wages withheld pre-tax from their paycheck and deposited in an account that they can use for the reimbursement of costs associated with childcare.[10] As a DCAP, these sums are not subject to federal tax withholding, social security, Medicare, or federal unemployment tax.

Employers should report the value of all dependent care assistance provided to an employee under a DCAP in box 10 of the employee's Form W-2.[11] They should include any amounts that cannot be excluded from the employee's wages in boxes 1, 3, and 5.[12] Employers must report in box 10 both the nontaxable portion of assistance (up to $5,000) and any assistance above that amount that is taxable to the employee.[13] Reimbursements that are not excludable under § 129 are includable in the employee's gross income and wages.[14]

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Critically, payments made to employees under DCAPs **must be issued pursuant to a written plan of the employer that satisfies IRC § 129(d)**, in order to be tax-free under IRC § 129. Employers are therefore well advised to establish a DCAP **before** receiving payments under the ECCAP, such that both the employer and its employees can reap the full tax benefits.

Federal, State, and Local Tax Implications of ECCAP Payments

At the state level, because Kentucky generally follows the Internal Revenue Code definitions of "gross income," the employer-provided portion of the contribution is subject to the ordinary rules of taxation of the childcare benefits of DCAPs, including the $5,000 or $2,500 limits. Additionally, Kentucky localities that impose an occupational license tax likewise generally follow the Internal Revenue Code's definition of gross income. So, the employer portion of the payments should be reported on the employee's W-2 as indicated above. Anything in excess of the applicable federal limit should be included in the state/local tax base, whereas anything below this amount should not.

The new government match portion of the contribution created by the ECCAP program will not be considered taxable income to the employee whatsoever. According to the language of the statute, "[a] state match issued pursuant to this program and administered by the cabinet is for the promotion of the general welfare and shall not be considered compensation for an employee's service."[15] This language makes it clear that Kentucky does not intend to count this payment towards the employee's gross income for state tax purposes, and it should not be reported as such.

At the federal level, the wording used by the legislative drafters in KRS § 199.885 cited above carefully invokes the IRS's general welfare exclusion to also exclude the state match payments from being counted as gross income for the employee.[16] The general welfare exclusion is a longstanding, non-statutory rule, based on IRS administrative rulings, that excludes legislative payments under social benefit programs that promote the general welfare from being calculated into gross income. The government match portion

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of the contribution should thus be treated for taxation purposes under the same category of receipts as Supplemental Security Income (SSI), SNAP, and other welfare payments.

Therefore, for any employer participating in the program, state match funds should not be included in an employee's W-2, either as gross income or as potentially excludable childcare benefits. These amounts also do not count towards the $5,000 or $2,500 cap on employer-provided tax-free benefits. Only the employer's own contributions should be included on the employee's Form W-2.

Example of Tax Implications for ECCAP Payments

For example, let's say an employer, ABC Corp., successfully applies to participate in the ECCAP and sets up a DCAP for their employees. Employee A lives and works in Jefferson County, is a single mother with sole custody of one child, and earns $50,000 per year; this falls below 100% of median household income in Kentucky for a household of two. Thus, ABC Corp. qualifies to receive a 100% match from the Commonwealth for any contribution. ABC Corp. decides to provide a $5,000 annual childcare benefit to Employee A; thus the Commonwealth may match $5,000.

ABC Corp. will not withhold federal, state, or local taxes on the $5,000 employer-provided payment or the $5,000 match from the Commonwealth. ABC Corp. will report the employer-provided payment, but not the state match payment, in Box 12 of Employee A's Form W-2.

Now, let's say ABC Corp. decides to provide an increased benefit to Employee A of $7,500 per year. The Commonwealth may still match the $7,500 amount even though it exceeds the nontaxable employer-match amount. Now, while ABC Corp. will continue to not withhold on the first $5,000 of employer-provided payments and will not withhold *at all* on any of the state match payments, it must withhold federal, state, and local taxes (including FICA taxes) on the remaining payments and include such payments in its own tax base for FICA tax purposes. The excess payments will be reported as income on Employee A's Form W-2, with $5,000 reported as nontaxable in Box 12.

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For more information or questions about navigating the tax implications of this new program or setting up a Dependent Care Assistance Program plan, please contact the authors or any attorney in Frost Brown Todd's Tax or Employee Benefits & ERISA practice groups. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state, and local tax planning and tax administration.

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[1] Ky. Rev. Stat. Ann. § 199.881.

[2] Ky. Rev. Stat. Ann. § 199.885.

[3] *Id.*

[4] *Id.*

[5] Ky. Rev. Stat. Ann. §§ 199.881 to 199.888.

[6] Kentucky Chamber of Commerce, "Employee Child Care Assistance Partnership: FAQ", available at:

https://www.kychamber.com/sites/default/files/pdfs/Employee%20Child%20Ca
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[7] Ky. Rev. Stat. Ann. § 199.885. *See also* Employee Child Care Assistance Partnership (ECCAP) Program, https://kynect.ky.gov/benefits/s/eccap-program?language=en_US.

[8] Kentucky Chamber of Commerce, "Child Care Resources for the Kentucky Business Community", available at: https://www.kychamber.com/sites/default/files/pdfs/Child%20Care%20Resourc
10-22%20%28003%29.pdf.

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] IRS Notice 2021-26, "Taxation of Dependent Care Benefits Available Pursuant to an Extended Claims Period of Carryover", available at: https://www.irs.gov/pub/irs-drop/n-21-26.pdf.

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[15] Ky. Rev. Stat. Ann. § 199.885.

[16] Congressional Research Service, IN FOCUS, "The IRS's General Welfare Exclusion", available at: https://sgp.fas.org/crs/misc/IF12326.pdf.

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