



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE
MEMORANDUM FOR

FROM: Assistant Chief Counsel
(Employee Benefits and Exempt Organizations)
CC:EBEO:BR4

SUBJECT: Problem Solving Day - Earned Income Credit Issue

This responds to your memorandum dated October 19, 1998, regarding whether nontaxable disability income attributable to premiums paid by an employee is included in the computation for the earned income credit.

ISSUE:

Whether nontaxable disability income attributable to premiums paid by an employee is included in the computation for the earned income credit (EIC).

CONCLUSION:

Nontaxable disability income attributable to premiums paid by an employee is not "earned income" for purposes of the EIC.

FACTS:

Employees participate in disability policies through their employers. Under the terms of the policies, the employer and employees each pay a portion of the premiums.

After an employee becomes disabled and receives payments under the disability policy, the employee's Form W-2, Wage and Tax Statement, shows the amount of the payments attributable to the premiums paid by the employer in

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Box 1, Wages, tips, other compensation. The amount attributable to the premiums paid by the employee may be reported in Box 13 and is excluded from wages.¹

You question whether such an employee may claim the earned income credit on the entire amount of disability income (the amount reported in Box 1 plus the amount reported in Box 13) or only on the amount attributable to the premiums paid by the employer (the amount reported in Box 1).

LAW AND ANALYSIS:

Section 32 of the Internal Revenue Code provides that qualified taxpayers are entitled to an earned income credit (EIC). The amount of the EIC is based, in part, on the taxpayer's earned income.

Section 32(c)(2)(A)(i) defines "earned income" in the case of an employee, as "wages, tips, and other employee compensation."

Section 1.32-2(c)(2) of the Income Tax Regulations provides, in part, that for purposes of section 32, earned income includes compensation excluded from gross income, such as disability income excluded under section 105(d).

Section 105(d) was repealed for tax years beginning after 1983. Prior to its repeal, section 105(d) provided that in the case of a taxpayer who had not reached age 65, who retired on disability, and who was permanently and totally disabled when he or she retired, gross income did not include amounts received by an employee under an accident or health plan to the extent that the amounts were attributable to employer contributions that were not included in the employee's gross income. This was the case only if such amounts constituted wages or payments in lieu of wages for a period when the employee was absent from work on account of permanent and total disability. This exclusion was limited to \$100 per week and was phased out for taxpayers whose adjusted gross income exceeded \$15,000.

Thus, for tax years before the repeal of section 105(d), the amount of the disability benefits attributable to the employer's contribution would have been excluded from gross income. These amounts, however, would have been "earned income" under section 1.32-2(c)(2) of the regulations for purposes of the EIC

¹ The instructions to Form W-2, Box 13 state to use the code "J" for nontaxable sick pay, which is described as any sick pay not includible in income because the employee contributed to the sick pay plan.

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despite their exclusion from gross income.² For tax years after the repeal of section 105(d), the amount of the disability benefits attributable to the employer's contributions is now included in gross income. Such amounts remain "earned income" for the EIC.

Your issue, however, is whether the disability benefits attributable to an employee's contribution are earned income. These benefits are not wages or tips, so the only question is whether they are "other employee compensation." If they are, they will be earned income despite their being excludible from gross income. But disability benefits attributable to employee contributions are received in exchange for the employee's payment of a portion of the premiums, rather than in exchange for the employee's services. Consequently, such disability benefits are not compensation and thus not earned income for purposes of the EIC.

If you have any further questions, please call (202) 622-6060.

Assistant Chief Counsel
(Employee Benefits and Exempt
Organizations)

By: _____
MARK SCHWIMMER
Branch Chief
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² For tax years beginning before January 1, 1979, only amounts that were includible in a taxpayer's gross income for the taxable year were taken into account in determining earned income. This provision was repealed for tax years beginning after December 31, 1978. Thus, whether the employee compensation is includible in the taxpayer's income is no longer relevant.