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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

REG-160315-03

RIN 1545-BC89

Sickness or Accident Disability Payments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of payments made on account of sickness or accident disability under a workers' compensation law for purposes of the Federal Insurance Contributions Act (FICA).

DATES: Written and electronic comments must be received by June 9, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-160315-03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-160315-03), Courier-s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayer may submit comments electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via Federal Rulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS and REG-160315-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Ford of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), (202) 622-6040; concerning submissions of comments, the hearing and/or to be placed on the building access list to attend the hearing, Lanita Van Dyke (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to 26 CFR part 31 under section 3121 of the Internal Revenue Code (the Code.) Section 3121(a)(2)(A) of the Code excepts from “wages” for FICA tax purposes payments to an employee or any of his dependents on account of sickness or accident disability only if the payments are received under a “workmen’s compensation law”, hereinafter referred to as a workers’ compensation law. The amendment to the regulations provides that for purposes of section 3121(a)(2)(A) a workers’ compensation law includes a statute in the nature of a workers’ compensation act.

**Explanation of Provisions**

**Current Law**

Section 3121(a) defines wages for FICA purposes as all remuneration for employment unless specifically excepted. Section 3121(a)(2)(A) excepts from wages the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to or on behalf of, an employee or any of his dependents under a plan or system

established by an employer which makes provision for his employees generally (or for his employees generally and their dependents) or for a class or classes of his employees (or for a class or classes of his employees and their dependents), on account of sickness or accident disability, but only if the employee receives the payments under a workers' compensation law. Section 3121(a)(4) provides that wages does not include any payment on account of sickness or accident disability made by an employer to or on behalf of an employee after the expiration of 6 calendar months following the last calendar month in which the employee worked for the employer. Thus, unless made under a workers' compensation law, payments received on account of sickness or accident disability are wages subject to FICA during the first 6 months the employee is out of work.

Prior to its amendment by section 3(b)(1) of Public Law 97-123, (95 Stat. 1659 1982-6 I.R.B. 7) (the 1981 Act), section 3121(a)(2)(B), the predecessor to section 3121(a)(2)(A), excluded from wages any payments made under a plan or system established by an employer on account of sickness or accident disability. There was no requirement that payments be made under a workers' compensation law. Thus, the 1981 Act narrowed the sick pay exclusion by limiting the exclusion from FICA to payments made under a worker's compensation law. Section 3(e) of the 1981 Act did not amend the Code, but specifies for purposes of section 3121(a) of the Code that a payment under a workers' compensation law does not include a payment made pursuant to a State temporary disability insurance law.

On July 6, 1982, the IRS issued Temporary regulations (TD 7823, 47 FR 29225, July 6, 1982). Section 32.1 (a)(1) of the Temporary Employment Tax Regulations follows the amendments made by the 1981 Act providing that payments on account of sickness or accident disability are excluded from wages for FICA purposes only if paid under a workers' compensation law. Section 32.1(a)(1). Further, Section 32.1(c) provides that a payment under a workers' compensation law does not include a payment made pursuant to a State temporary disability insurance law. Thus, such payments are wages for FICA purposes. The temporary regulations do not address the FICA tax treatment of payments made under a statute in the nature of a workers' compensation act.<sup>1</sup> For income tax purposes, section 104(a)(1) provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness. Section 1.104-1(b) of the Income Tax Regulations states that section 104(a)(1) of the Code excludes from gross income amounts received by an employee under a workers' compensation act or under a statute in the nature of a workers' compensation act that provides compensation to the employee for personal injury or sickness incurred in the course of employment.

The IRS takes the position that gross income for income tax purposes is a separate concept from wages for purposes of FICA. Furthermore, exclusions from wages for FICA purposes are to be construed narrowly. Thus, amounts that

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<sup>1</sup> To provide guidance relating to changes made by the Act the IRS published Revenue Procedure 82-20 (1982-1 C.B. 466), which provided in Q&A 1 that payments under a statute in the nature of a workers' compensation act were excluded from FICA. Rev. Proc 82-20 was obsolete by Revenue Procedure 95-43 (1995-2 C.B. 412), which provides that the temporary regulations generally restate the guidance in Q&A-1 through Q&A-9 of Rev. Proc. 82-20.

are excluded from gross income, in the absence of a specific statutory or regulatory exclusion from wages, constitute wages for FICA.

Pursuant to the income tax regulations, payments made under a statute in the nature of a workers' compensation act are excluded from gross income under section 104. However, there is no regulation at present addressing whether such payments are excluded from wages for FICA purposes.

Through 1989, the IRS issued several private letter rulings concluding that payments made under a statute in the nature of a workers' compensation act were excluded from gross income and exempt from FICA. In 1990, based on the Service's position that the exclusion from gross income did not necessarily result in an exclusion from wages, and the absence of a regulation on point, the IRS reversed its ruling position with respect to FICA, holding that payments made under a statute in the nature of a workers' compensation act are included in wages, until the employee has been absent from work in excess of six months; once the employee has been absent from work for more than six months, the payments are excluded from FICA by section 3121(a)(4).

Questions have arisen concerning the FICA tax treatment of payments made under a statute in the nature of a workers' compensation act to employees of states and local governments who are not eligible to receive payments under a workers' compensation law. Accordingly, the IRS and Treasury are seeking to provide rules to clarify the treatment of such payments during the first six months the employee is out of work.

Under the proposed regulations, payments made under a statute in the nature of a workers' compensation act will be treated as having been made under a workers' compensation law and, therefore, will be excluded from wages for FICA purposes. Thus, the regulations adopt the same position that was published in Rev. Proc. 82-20, the most contemporaneous guidance to the legislation that created the current statutory scheme. The proposed regulations thus align the interpretation of what constitutes payments received under a workers' compensation law for purposes of section 3121(a)(2)(A) with the interpretation of amounts received under a workers' compensation law for purposes of section 104(a)(1).

These proposed regulations are intended to address only the treatment of payments under a statute in the nature of a workers' compensation act for FICA purposes. The existing temporary regulations under section 31.1 which address the FICA treatment of payments under a workers' compensation law also provide guidance to third parties making payments on account of sickness or accident disability. Treasury and the IRS are not proposing any changes to the regulations with respect to the FICA treatment of third-party sick pay. To the extent it is necessary to modify the temporary regulations to harmonize them with these proposed regulations, the third-party sick pay provisions will be preserved. To the extent necessary, future guidance will also address the treatment of payments on account of sickness or accident disability for Federal Unemployment Tax Act and Railroad Retirement Tax Act purposes.

### **Proposed Effective Date**

It is proposed that these regulations apply to payments made on or after the date the proposed regulation is published as Final in the Federal Register.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small business.

### **Comments and Requests for Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled,

notice of the date, time, and place for the public hearing will be published in the Federal Register.

### **Drafting Information**

The principal author of these regulations is David Ford of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 31**

Employment taxes and collection of income at the source.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

#### **PART 31 -- EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE**

Paragraph 1. The authority section for part 31 continues to read, in part, as follows:

Authority 26 U.S.C. 7805 \* \* \*

Par. 2. Section 31.3121(a)(2)-1 is amended by:

1. Revising the section heading.
2. Removing paragraph (a)(1).
3. Redesignating paragraphs (a)(2) through (a)(4) as (a)(1) through (a)(3), respectively.
4. Revising paragraph (a)(1).
5. Redesignating paragraph (d) as paragraph (f).

6. Adding paragraphs (d) and (e).

The revisions and additions are as follows:

§31.3121(a)(2)-1 Payments on account of sickness or accident disability, medical or hospitalization expenses, or death.

(a) \* \* \*

(1) Sickness or accident disability of an employee or any of his dependents, only if payment is received under a workers' compensation law;

(2) Medical or hospitalization expenses in connection with sickness or accident disability of an employee or any of his dependents, or

(3) Death of an employee or any of his dependents.

\* \* \* \* \*

(d) Workers' compensation law. (1) For purposes of paragraph (a)(1) of this section, a payment made under a workers' compensation law includes a payment made pursuant to a statute in the nature of a workers' compensation act.

(2) For purposes of paragraph (a)(1) of this section, a payment made under a workers' compensation law does not include a payment made pursuant to a State temporary disability insurance law.

(3) If an employee receives a payment on account of sickness or accident disability that is not made under a workers' compensation law or a statute in the nature of a workers' compensation act, the payment is not excluded from wages as defined by section 3121(a)(2)(A) even if the payment must be repaid if the employee receives a workers' compensation award or an award under a statute

in the nature of a workers' compensation act with respect to the same period of absence from work.

(4) If an employee receives a payment on account of non-occupational injury sickness or accident disability such payment is not excluded from wages, as defined by section 3121(a)(2)(A).

(e) Examples. The following examples illustrate the principles of paragraph (d) of this section:

Example 1. A local government employee is injured while performing work-related activities. The employee is not covered by the State workers' compensation law, but is covered by a local government ordinance that requires the local government to pay the employee's full salary when the employee is out of work as a result of an injury incurred while performing services for the local government. The ordinance does not limit or otherwise affect the local government's liability to the employee for the work-related injury. The local ordinance is not a workers' compensation law, but it is in the nature of a workers' compensation act. Therefore, the salary the employee receives while out of work as a result of the work-related injury is excluded from wages under section 3121(a)(2)(A).

Example 2. The facts are the same as in Example 1 except that the local ordinance requires the employer to continue to pay the employee's full salary while the employee is unable to work due to an injury whether or not the injury is work-related. Thus, the local ordinance does not limit benefits to instances of work-related disability. A benefit paid under an ordinance that does not limit benefits to instances of work-related injuries is not a statute in the nature of a workers' compensation act. Therefore, the salary the injured employee receives from the employer while out of work is wages subject to FICA even though the employee's injury is work-related.

Example 3. The facts are the same as in Example 1 except that the local ordinance includes a rebuttable presumption that certain injuries, including a heart attack incurred by a firefighter or other law enforcement personnel is work-related. The presumption in the ordinance does not eliminate the requirement that the injury be work-related in order to entitle the injured worker to full salary.

Therefore, the ordinance is a statute in the nature of a workers' compensation act, and the salary the injured employee receives pursuant to the ordinance is excluded from wages under section 3121(a)(2)(A).

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Mark E. Matthews,  
Deputy Commissioner of Services and Enforcement.