



OFFICE OF  
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DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR:

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

SUBJECT: Earned Income Credit and Foster Care Payments

This is in response to your memorandum dated March 29, 1999, about the treatment of foster care payments for purposes of the earned income credit (EIC).

ISSUE:

Are foster care payments considered "earned income" for purposes of the earned income credit (EIC)?

CONCLUSION:

Foster care payments that are excluded from gross income under section 131 of the Internal Revenue Code are not "earned income" for purposes of the EIC. Foster care payments that are included in gross income may be earned income for purposes of the EIC, depending on the facts.

FACTS:

While not providing a specific fact situation, you referenced language in Publication 17 outlining the circumstances under which foster care payments are treated as taxable or nontaxable income. The language in Pub. 17 is based on section 131 of the Code. Our response addresses foster care payments that are excluded from gross income under section 131 and provides a framework for

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determining whether payments that do not meet the requirements of section 131 are earned income.

### LAW AND ANALYSIS:

Section 32 of the Code provides that certain 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" as wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year (within the meaning of section 1402(a)), but the net earnings shall be determined with regard to the deduction allowed to the taxpayer by section 164(f). "Net earnings from self-employment" is the gross income derived by an individual from any trade or business carried on by the individual, less deductions attributable to the trade or business, and certain adjustments specified by law.

Section 131 of the Code excludes "qualified foster care payments" from gross income. Section 131(b)(1) defines a "qualified foster care payment," in part, as any amount (A) which is paid by a state or political subdivision thereof or by a placement agency which is described in section 501(c)(3) and exempt from tax under section 501(a), and (B) which is (i) paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home, or (ii) a difficulty of care payment, as defined in section 131(c). Section 131 of the Code also limits the exclusion based on the age and the number of individuals for whom foster care is provided.

Thus, in order for foster care payments to constitute earned income for EIC purposes, the payments must either be an employee's wages, salaries, tips, or other compensation, or be a self-employed individual's net earnings from self-employment.

To determine whether foster care providers are employees or self-employed, one must examine the common law rules, which are explained in section 31.3121(d)-1(c) of the Employment Tax Regulations. An employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished.

While there may be situations where a foster care provider is an employee of the placement agency, we believe this would be unlikely. It is much more likely that the foster care provider is either providing foster care gratuitously (not for profit) to

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the placement agency or is self-employed in the trade or business of providing foster care. For purposes of this memorandum, therefore, we are assuming the foster care provider is not an employee of the placement agency.

Because we are assuming the foster care provider is not an employee, the foster care payments can only be earned income if they are net earnings from self-employment. This, in turn, can occur only if the payments are included in the foster care provider's gross income. Thus, if the foster care payments are excluded from gross income under section 131 of the Code, the payments would not be earned income for purposes of the EIC.

If the foster care payments are not excluded from gross income, then, in the case of a foster care provider who is providing gratuitous services<sup>1</sup> to the placement agency, the payments would not be earned income because the foster care provider would not have net-earnings from self-employment. In the case of a foster care provider who is engaged in the trade or business of providing foster care, the payments would be gross income derived from a trade or business. This amount would be used to compute the net-earnings from self-employment, if any. Any net earnings from self-employment, determined with regard to the section 164(f) deduction, would be 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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<sup>1</sup> If the amount of the foster care payment is calculated to reimburse only the amount of expenses incurred by the foster care provider in caring for the foster child, it seems likely that the foster care provider is providing gratuitous services to the placement agency rather than being in a trade or business.