

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: John Chinnapongse  
Associate Area Counsel (SBSE)  
Sacramento

from: Robert M. Brown  
Associate Chief Counsel  
(Income Tax and Accounting)

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subject: California Paid Family Leave

You have requested our views regarding the tax consequences of Family Temporary Disability Insurance (FTDI) payments made under California's Paid Family Leave Program. Specifically, you have asked (1) whether the amounts withheld from employees' paychecks for FTDI are deductible under § 164 of the Internal Revenue Code, and (2) whether amounts paid to an individual under the program are includible in gross income under § 85 if (a) an individual does not itemize deductions on a federal income tax return, or (b) an individual itemizes deductions on a federal income tax return.

**FACTS**

Effective January 1, 2004, the State of California amended its State Unemployment Insurance Code to include FTDI as a component of its disability insurance program. FTDI payments are made to eligible individuals who are unable to work because they are caring for a seriously ill or injured family member, or bonding with a minor child within one year of the birth or placement of the child in connection with foster care or adoption. Thirteen million Californians will be covered by this program.

FTDI payments will be paid from the State disability fund, and will be funded entirely by employee contributions. The payroll deductions are mandatory.

Eligible individuals can receive up to 6 weeks of FTDI payments in a 12-month period. An individual is not eligible to receive an FTDI payment for the same days the individual receives or is entitled to receive unemployment compensation, disability insurance, or other cash benefits from the State, any other state, or the Federal government.

## **ISSUE 1**

**Are the amounts withheld from employees' paychecks under this program deductible under § 164?**

## **HOLDING**

**Such amounts are deductible by the employee under § 164(a)(3) for the taxable year in which paid or accrued, but only if the employee's deductions are itemized in computing taxable income under § 63.**

## **ANALYSIS**

Section 164(a)(3) provides, in part, that state income taxes shall be allowed as a deduction for the taxable year in which they are paid or accrued.

Principles developed under federal law, not state interpretations or designations, determine whether a payment falls within the meaning of terms 'taxes' and 'income taxes' as used in federal statutes. See Rev. Rul. 79-180, 1979-1 C.B. 95; Rev. Rul. 76-215, 1976-1 C.B. 194; Rev. Rul. 71-49, 1971-1 C.B. 103; and Rev. Rul. 61-152, 1961-2 C.B. 42.

The word 'taxes' has been defined as an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes and not as a payment for some privilege granted or service rendered. See Rev. Rul. 77-29, 1977-1 C.B. 44; Rev. Rul. 71-49; Rev. Rul. 61-152; and Rev. Rul. 58-141, 1958-1 C.B. 101. Further, it is the position of the Service that a tax must be paid to a government levying the tax, to certain public corporations created by that government for a public purpose, or to their agents. See Rev. Rul. 74-525, 1974-2 C.B. 411, Rev. Rul. 74-58, 1974-1 C.B. 180; and Rev. Rul. 71-49.

In Rev. Rul. 81-191, 1981-2 C.B. 49, employees were required to contribute to the Rhode Island temporary disability insurance benefit fund pursuant to the Rhode Island Temporary Disability Insurance Act (Act). The employer was required to withhold the amount of such contributions from the employees' wages at the time the wages were paid. If the employer failed to withhold the contributions of any employee within the

time provided by the Act, the employer became solely liable for such contributions under the Act.

Rev. Rul. 81-191 holds that the contributions withheld from the wages of an employee are state 'income taxes' that are deductible by the employee under § 164(a)(3), provided that the employee itemizes deductions in computing taxable income. Rev. Rul. 81-191 reasons that the employee contributions to the fund are 'taxes' because they are exacted pursuant to legislative authority in the exercise of the taxing power of the state, and they are imposed and collected by the state for the purpose of raising revenue to be used for governmental functions that serve public purposes. The ruling further reasons that the employee contributions to the fund are 'income taxes' because they are measured by wages paid during the calendar year. For similar results and rationale, see Rev. Rul. 81-192, 1981-2 C.B. 50 (New York); Rev. Rul. 81-193, 1981-2 C.B. 52 (New Jersey); and Rev. Rul. 81-194, 1981-2 C.B. 54 (California).

In California, the contributions under its FTDI program are taxes. The law requires employers to withhold a portion of each employee's wages at the time the wages are paid. These withheld and contributed amounts are exacted pursuant to legislative authority in the exercise of the taxing power of the State of California, and are imposed and collected for the purpose of raising revenue to be used for a governmental function that serves public purposes, namely, to allow individuals to take time off from work to care for a seriously ill child, parent, or domestic partner; or to bond with a new child.

Moreover, the amounts withheld from the employees' wages are 'income taxes' because they are measured by wages paid during the calendar year. See Rev. Rul. 81-191, and *Trujillo v. Commissioner*, 68 T.C. 670 (1977).

Consequently, amounts withheld from the wages of an employee for contribution under this program are state income taxes and, therefore, shall be deductible by the employee under § 164(a)(3) for the taxable year in which paid or accrued. However, such amounts are deductible by an employee only if the employee's deductions are itemized in computing taxable income under § 63.

If you have any questions about Issue 1, please contact Erika Reigle at (202) 622-4950.

## **ISSUE 2**

**Are FTDI payments includible in gross income under § 85 if:**

- (a) an individual does not itemize deductions on a federal income tax return; or**
- (b) an individual itemizes deductions on a federal income tax return.**

## **HOLDING**

**Individuals who do not itemize deductions include only the amount in excess of their contributions in income. Individuals who itemize deductions include the full amount of the FTDI payment in income, but take an income tax deduction equal to the amount of their contributions.**

## **ANALYSIS**

Section 85 provides that gross income includes unemployment compensation. Under § 85(b), unemployment compensation is defined as any amount received pursuant to a state or Federal government program which is in the nature of unemployment compensation. Section 85 does not define “in the nature of unemployment compensation.” However, the House Report provides that “unemployment compensation programs are those designed to provide cash benefits on a regular basis to normally employed workers during limited periods of unemployment.” H.R. Rep. 95-1445 at 48. Prior to enactment of § 85, the Service taxed unemployment compensation benefits received under private plans but exempted those received under a governmental plan as a social welfare benefit. In explaining the reason for the change, the Committee on Ways and Means stated, “unemployment compensation paid under a government program should be includible in gross income because such benefits are, in substance, a substitute for taxable wages.” H.R. Rep. 95-1445 at 47.

The FTDI payments provide a substitute for taxable wages and are in the nature of unemployment compensation. This conclusion is not changed by the determination of how an individual prepares his or her individual income tax return. However, based on § 1.85-1(b)(1)(iii) of the Employment Tax Regulations, the amount an individual reports as gross income is affected by whether or not the individual itemizes deductions.

Section 1.85-1(b)(1)(iii) provides:

If a governmental unemployment compensation program is funded by an employee contribution which is not deductible by the employee, an amount paid to such employee under the program is not to be considered unemployment compensation until an amount equal to the total nondeductible contributions paid by the employee to such program has been paid to such employee.

Thus, in essence, if an individual does not take an income tax deduction equal to his or her contributions to the governmental plan, only amounts in excess of the individual's basis in the fund are includible in gross income. Conversely, if an individual does deduct his or her contribution to the governmental plan, the entire amount of the payment is includible in gross income.

This provides equal tax treatment to each category of filer. Those individuals who do not itemize deductions include only the amount in excess of their contributions in income. Those individuals who do itemize deductions include the full amount of the

FTDI payment in income, but take an income tax deduction equal to the amount of their contributions. Thus, the net result is that each individual is taxed on only the amount of the FTDI payment that is in excess of his or her contribution.

If you have any questions about this issue, please contact \_\_\_\_\_ at \_\_\_\_\_

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We hope this information is helpful. For any other questions, please contact \_\_\_\_\_ at \_\_\_\_\_