***Cato v. Commissioner, 99 T. C. 633, 1992 U. S. Tax Ct. LEXIS 89, 99 T. C. No. 33 (1992)***

Foster care payments, including those from SSI funds administered by a State-licensed nonprofit agency, are excludable from gross income under IRC Section 131, but excess payments over expenses before 1986 are subject to self-employment tax.

**Summary**

Bobby L. Cato operated a licensed Small Family Home (SFH) in California, receiving payments for foster care, including Supplemental Security Income (SSI) funds. The issue was whether these payments were excludable from gross income under IRC Section 131 and subject to self-employment tax. The court held that post-1985, all foster care payments were excludable from gross income under Section 131, as they were administered by a qualifying agency. However, for 1985, the excess of foster care receipts over expenses was taxable as self-employment income due to Cato's profit motive. The decision clarified the application of Section 131 and its implications for foster care providers.

**Facts**

Bobby L. Cato ran a Small Family Home (SFH) licensed by the California Department of Social Services, providing care for developmentally disabled children. He received payments from two regional centers, which were nonprofit agencies qualifying under IRC Section 501(c)(3). These payments included both state funds and Supplemental Security Income (SSI) funds, which the regional centers received on behalf of the children and then transferred to Cato. For 1985, Cato reported the foster care payments as business income on Schedule C, offsetting it with claimed SSI contributions. From 1986 to 1988, Cato received payments that included both state and SSI funds, with the regional centers issuing Forms 1099 for the total amounts transferred.

**Procedural History**

The Commissioner determined deficiencies in Cato's federal income taxes for the years 1985 to 1988, asserting that SSI payments were not excludable under Section 131 and that the foster care receipts were subject to self-employment tax. Cato petitioned the Tax Court, which held that post-1985 foster care payments, including SSI funds, were excludable from gross income under Section 131. However, for 1985, the court found that the excess of foster care receipts over expenses was subject to self-employment tax.

**Issue(s)**

1. Whether Supplemental Security Income (SSI) payments received by Cato in 1986, 1987, and 1988 for caring for developmentally disabled children are excludable from income under Section 131.

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2. Whether foster care receipts from the operation of Cato's Small Family Home are subject to self-employment tax for the years at issue.

**Holding**

1. Yes, because Section 131 excludes from gross income all foster care payments received from a qualifying agency, including those funded by SSI, as they are administered by a State-licensed nonprofit agency.
2. No, for 1986, 1987, and 1988, because these payments are excluded from gross income under Section 131 and thus not subject to self-employment tax. Yes, for 1985, because the excess of foster care receipts over expenses is taxable as self-employment income due to Cato's profit motive.

**Court's Reasoning**

The court interpreted Section 131 to exclude all foster care payments, including SSI funds, from gross income if administered by a qualifying agency, as per the legislative intent to simplify record-keeping for foster parents. The court rejected the Commissioner's conduit theory, emphasizing that the regional centers benefited from handling SSI funds and that the source of funds was irrelevant for Section 131's application. For self-employment tax, the court relied on the legislative history of Section 131 and Rev. Rul. 77-280, concluding that pre-1986 excess foster care payments over expenses were taxable as self-employment income if the foster care activity was conducted with a profit motive.

**Practical Implications**

This decision clarifies that post-1985 foster care payments, including SSI funds, are excludable from gross income if administered by a qualifying agency, simplifying tax compliance for foster parents. However, it also establishes that pre-1986 excess payments over expenses are subject to self-employment tax if the foster care activity is conducted with a profit motive. Legal practitioners should advise foster care providers accordingly, ensuring accurate reporting of income and expenses, particularly for years before the 1986 amendment. This ruling may influence how foster care agencies structure their payment systems and how foster parents manage their finances to align with tax regulations.

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