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District Counsel,
Attn:

Assistant Chief Counsel (Employee Benefits and Exempt Organizations)
Patricia McDermott

Significant Service Center Advice -

This memorandum is a reconsideration of the issues raised in your request for significant service center advice, dated June 25, 1997, concerning the proper amount and reporting of compensation received by employees of international organizations who are United States citizens.

Issues

1. What is the correct method of calculating reportable compensation for employees of international organizations who are U.S. citizens?

2. How should U.S. citizen employees report their compensation on Form 1040?

3. Should the advice in this memorandum be applied retroactively?

Conclusions

1. Reportable compensation for employees of international organizations who are U.S. citizens is gross salary minus the mandatory reduction, but including the tax reimbursement paid during the year.

2. Employees of international organizations who are U.S. citizens should report their compensation on line 7 of Form 1040, as "wages, salaries, tips, etc.," and on Schedule SE.

3. We recommend that the advice in this memorandum not be applied retroactively.

Facts

Your inquiry deals with U.S. citizens who are employees of international organizations, as defined in section 7701(a)(18) of the Internal Revenue Code (the Code). The compensation provided to employees of international organizations commonly consists of a nominal gross salary, which is subject to a mandatory reduction. All employees are subject to the reduction. Amounts representing the reduction are retained by the organizations for their own use. The reduction is neither credited to nor used for the benefit of the particular employee to whose compensation it was applied. Thus the employee's gross salary is a fiction.

Employees of international organizations who are citizens of the United States must pay U.S. federal taxes, as well as state taxes and local taxes, on their compensation. Employees of international organizations who are not U.S. citizens are generally not subject to U.S. federal, state or local taxation. In order to provide comparable net compensation to all their employees, international organizations commonly reimburse U.S. employees for their federal, state and local taxes. The amount of a U.S. employee's tax reimbursement may be based on an approximation of the employee's tax liabilities.

It appears that some years ago the Internal Revenue Service advised that, for federal tax purposes, it was acceptable to report the amount of an international organization employee's gross salary, rather than an amount that reflects the mandatory reduction and the tax reimbursement.

Analysis

1. What is the correct method of calculating reportable compensation for employees of an international organization who are U.S. citizens?

Code section 61(a)(1) provides that gross income includes compensation for services. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929), holds that an employer's payment of an employee's federal tax liability is income to the employee. See also section 1.61-14(a), Income Tax Regulations, stating, "Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law."

Under section 1.451-1(a) of the Income Tax Regulations, gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer. Compensation is not constructively received, however, if the money has not been paid or made unconditionally available to the employee or made subject to the employee's control. See section 1.451-2(a).

It does not appear that employees of international organizations ever actually or constructively receive the mandatory reductions described above. We are unaware of any economic benefit, direct or indirect, received by the employees in connection with the unpaid reductions. The employees apparently do not receive possession, dominion, or control over the

mandatory reductions that the organizations treat on their books as a nominal part of the employees' salaries. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207. The amount of the reduction therefore is not compensation to the employee. However, the amount that a U.S. employee receives as a tax reimbursement is includible in the employee's compensation.

2. How should U.S. citizen employees report their compensation on Form 1040?

As noted above, section 61(a) includes compensation for services in gross income. Section 1.61-2(a)(1) of the Income Tax Regulations provides, in relevant part, that wages and salaries are income to the recipients unless excluded by law. In determining adjusted gross income, section 62(a) allows for the deduction of certain listed items from gross income. Section 62(a)(1) permits a taxpayer to deduct from gross income those deductions attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

Section 3101 of the Code imposes tax under the Federal Insurance Contributions Act (FICA) on employees' wages. Under the common-law rules, individuals working for international organizations would generally be categorized as employees. Code section 3121(d)(2). Code section 3121(b)(15), however, generally excludes from the definition of "employment" for FICA purposes services in the employ of an international organization.[1] Since their services are not employment, employees of international organizations do not receive "wages" for FICA purposes because section 3121(a) defines "wages" as all remuneration for employment.

Section 3402 of the Code requires that income tax be withheld from employees' wages. Code section 3401(a)(5) excludes from the definition of "wages" for purposes of federal income tax withholding remuneration paid for services by a citizen or resident of the United States for a foreign government or an international organization. Therefore, the compensation of an international organization's U.S. employees is not subject to income tax withholding as wages.

As discussed above, the compensation employees receive from international organizations is not subject to FICA tax. In order to provide employees with social security coverage, however, section 1402(c)(2)(C) extends the definition of a trade or business for determining Self-Employment Contributions Act (SECA) taxes to include employment with an international organization. Section 1402(c)(2)(C) provides, in part, that services described in

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[1]Section 3121(b)(15) cross-references section 3121(y), which defines "international organization" with reference to 5 U.S.C. section 3581(3). This section defines the term as follows: "a public international organization or international-organization preparatory commission in which the Government of the United States participates." This definition is somewhat more inclusive than the definition in section 7701(a)(18).

section 3121(b)(15) performed in the United States by a citizen of the United States constitute a trade or business for SECA purposes.

Section 1401 imposes SECA tax on an individual's self-employment income. For purposes of determining self-employment income, section 1402(a) defines net earnings from self-employment as the gross income derived by an individual from a trade or business less any deductions attributable to the trade or business. In Braddock v. Commissioner, 95 T.C. 639 (1990), the Tax Court held that a payment to an employee of an international organization intended to reimburse United States taxes paid was subject to SECA tax. The opinion states, "It is well established, and petitioner now concedes, that [the amount of the reimbursement] represents gross income under section 61 and is subject to the normal income tax imposed by chapter 1." See also Smart v. U.S., 222 F. Supp. 65 (S.D.N.Y. 1963) (holding imposition of SECA tax on employees of international organizations does not violate uniformity or due process requirements of constitution); Rev. Rul. 84-122, 1984-2 C.B. 184 (holding income tax reimbursements from international organization received in years after termination of employment are subject to SECA tax).

The proper line for reporting the income on Form 1040 depends upon the characterization of the income as either salary or gross income from a trade or business. The choice of the line for reporting the income raises various compliance questions. Additionally, there are some concerns about the proper method for computing self-employment income and SECA tax.

A. Reporting the income for income tax purposes

There appear to be three possible locations on Form 1040[2] for reporting the income paid by an international organization: (1) on line 7 as wages, salaries, tips, etc., (2) on Schedule C as business income or loss, and (3) on line 21 as other income.

The first alternative is reporting as wages or salaries. As discussed above, remuneration paid by an international organization to its employees does not constitute wages for purposes of FICA or income tax withholding. The definitions of wages in sections 3121(a) and 3401(a) are expressly limited, however, to the chapters of the Code in which they are found. Section 3121(a) defines wages for the purposes of chapter 21 of the Code (concerning FICA). Section 3401(a) defines wages for the purposes of Chapter 24 of the Code (concerning collection of income tax at source on wages).

The characterization of the income for income tax purposes should be governed by Chapter 1 of the Code. There is no provision in Chapter 1 that prevents the remuneration paid by an international organization to its employees from being classified as wages or salary. Since the remuneration paid by an international organization to its employees is compensation for services, the income should be reported on line 7 of Form 1040 as wages or salary.

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[2]Using the 1998 Form 1040 for the purposes of identifying line numbers.

Additionally, reporting the income on line 7 is consistent with the instructions the Service gives to ministers, whose salaries, like those of employees of international organizations, are not subject to either FICA tax or federal income tax withholding.[3] Publication 517 entitled "Social Security and Other Information for Members of the Clergy and Religious Workers,"[4] at 10, provides an example, stating that the church reports the remuneration on Form W-2, and the minister reports his compensation on line 7 as wages.

The second alternative, which is being used by some employees of international organizations, is reporting the compensation as trade or business income on Schedule C. However, section 1402(c) defines trade or business only for SECA purposes. Thus service performed in the employ of an international organization is a trade or business only for SECA purposes, not for income tax purposes generally.

Although section 3121(b)(15) provides that services performed in the employ of international organizations are not employment for FICA tax purposes, the employees of international organizations remain employees for income tax purposes. Since the workers are employees, they are not considered to carry on a trade or business, and reporting the income on Schedule C would be improper. Additionally, if international organization employees were to report their income on Schedule C, they might mistakenly deduct business expenses on Schedule C. Since these taxpayers are employees, they must deduct unreimbursed employee business expenses on Schedule A as miscellaneous itemized deductions subject to the 2 percent floor provided by section 67(a).

The final alternative is reporting the income on line 21 as "other income." Employees should not be advised to do this since reporting on that line would probably provide the least opportunity for the Service to correctly match the income reported on the employee's return with the income reported by the international organization.

B. Reporting net earnings from self employment

For SECA purposes, employees of international organizations should report their net earnings from self-employment on Schedule SE (either on section A, line 2 or section B, part 1, line 2). Since the employees can deduct expenses attributable to the trade or business in computing net earnings from self-employment and since the employees generally cannot deduct

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[3]Under the provisions of section 3121(b)(8), services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry are excluded from the term "employment." Since the services are not employment, the remuneration is not wages under section 3121(a). Under the provisions of section 1402(c)(4), the minister's services (as described in section 3121(b)(8)) constitute a trade or business for the purpose of determining self-employment taxes.

[4]For the purposes of this analysis, the publication for 1998 returns is cited.

the expenses attributable to the trade or business from their gross income in computing adjusted gross income, there must be a procedure for computing net earnings from self-employment. There is no place on Schedule SE for making the computation.

Publication 517, at 5-7, considers the business deductions and the computation of net earnings from self-employment for ministers, advising the minister to compute net earnings from self-employment by reducing gross income by unreimbursed business expenses.[5] In the comprehensive example in the publication, the Service advises the minister to attach a schedule computing the net earnings from self-employment to the Schedule SE. On the separate schedule, the minister deducts unreimbursed expenses attributable to the trade or business of being a minister from his salary to compute the net earnings from self-employment.

Since the Code provides similar tax treatment for employees of international organizations and for ministers, the reporting and computation of self-employment taxes should be the same for both types of employees. Employees of international organizations should compute net earnings from self-employment by subtracting employee business expenses from their salaries on a separate schedule. The amount computed should then be used on Schedule SE to compute self-employment tax.

In summary, the compensation received by an employee from an international organization should be reported by the employee on Form 1040, line 7 as wages, salaries, tips, etc. The employee should compute the amount of net earnings from self-employment by deducting employee business expenses from the compensation received on a separate schedule. That amount should be used on Schedule SE to compute self-employment tax.[6] For income tax purposes, the employee can deduct unreimbursed employee business expenses only on Schedule A as miscellaneous itemized deductions.

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[5]In Rev. Rul. 80-110, 1980-1 C.B. 190, the Service ruled that ministers could deduct unreimbursed employee business expenses from the salary they received from a church in computing net earnings from self-employment, although the unreimbursed employee business expenses were only deductible as miscellaneous itemized deductions for income tax purposes. However, as discussed in Publication 517, the deductibility of some expenses is subject to limitation.

[6]Note that only services performed in the employ of an international organization in the United States by United States citizens are subject to self-employment tax. The employee would have to account for that salary received due to services performed in the United States. See Rev. Rul. 67-153, 1967-1 C.B. 221, for a discussion of the method for allocating the income for services performed within and without the United States.

3. Should the advice in this memorandum be applied retroactively?

Not applying this advice retroactively appears to be consistent with established policy under section 7805(b). "The Secretary may prescribe the extent, if any, to which any ruling (including . . . any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect." Delegation Order No. 96 (Rev. 11), 1992-1 C.B. 490, delegates this authority to, among others, the Associate Chief Counsels. See section 301.7805-1(b), Procedural and Administrative Regulations.

Section 601.201(l)(5) of the Statement of Procedural Rules states that, except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively to the taxpayer for whom the letter ruling was issued or to a taxpayer whose tax liability was directly involved, provided in relevant part that: 1) there has been no misstatement or omission of material facts; 2) the facts at the time of the transaction are not materially different from the facts on which the ruling was based; 3) there has been no change in the applicable law, and 4) the taxpayer directly involved acted in good faith in relying on the ruling and the retroactive revocation would be to the taxpayer's detriment.

Although the Service did not issue a formal ruling on these issues, there is evidence that some years ago the Service received inquiries on behalf of international organizations and their employees and did formulate a position and communicate it in writing in response to those inquiries. It appears that both the law and our understanding of the facts at that time were essentially the same as they are today, but that our interpretation of the law has changed. Accordingly, criteria analogous to those in which relief has been granted under section 7805(b) are present, and we recommend that the advice in this memorandum not be applied retroactively.

Thus, with respect to the amount of compensation to be reported, two methods are acceptable, pending further guidance: 1) reporting of the amount of the employee's gross salary, or 2) reporting of the legally correct amount of gross income, i.e., salary net of the mandatory reduction but including the tax reimbursement. In addition, with respect to the mechanics of reporting on the Form 1040, we recommend that outreach or educational efforts be made. For example, a letter explaining the proper return procedures could be sent to employees of international organizations.

If you have questions, please contact us at (202) 622-6040.