DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MEG BONNER
EXAM MANAGER CT-RHODE ISLAND DISTRICT

FROM: Jerry Holmes
Branch Chief CC:TEGE:EOEG:ET2

SUBJECT: Expatriate Tax Services

In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

1. Whether the value of income tax return preparation services provided to expatriate employees is excludable from the employees' gross incomes.

2. If the value of the income tax return preparation services is not excludable from gross income, whether this amount is wages for employment tax purposes.

CONCLUSIONS

1. The value of employer-provided income tax return preparation services is includible in the recipient employees' gross incomes. All fringe benefits are includible in gross income unless specifically excluded. These benefits are not excludable as a working condition fringe.

2. The value of the income tax return preparation services are wages subject to FICA and FUTA tax. However, for income tax withholding purposes, while not excludable from wages as a working condition fringe, the value of the benefit may be excludable if the employer reasonably believed at the time the benefit was provided that the value of the benefit was excludable from the recipient-employee's gross income under section 911 of the Code.

FACTS

The facts in this case are not taxpayer-specific. Instead, you have described the following facts as being typical of those present in several cases.

The Company is a corporation organized under state law. It has employees who perform services overseas. The Company wishes to compensate its employees fairly for working overseas. Toward that end, the Company has developed a program to equalize housing costs and other personal living costs, as well as income tax costs, incurred by its expatriate employees.

As part of its cost equalization program, the Company, through the services of a professional services firm, calculates an additional amount the Company must pay the expatriate employee (or an amount the employee must pay the Company) to equalize income tax costs of the expatriate employee with the income tax costs that the employee would owe if the employee worked in the United States. Depending upon the taxes that are projected to be owed in the host country, the employee may receive either an advance or have amounts deducted from the employee's pay during the year.

To administer the cost equalization program, the Company pays fees to a professional services firm to assist expatriate employees in determining host country taxes and completing any tax returns required by the host country. The professional services firm also prepares the expatriate employees' individual United States income tax returns. In addition, the professional services firm calculates and advises the Company regarding tax equalization payments due the Company or owed to the Company. After the employee files the required income tax returns after year-end, the professional services firm compares the actual tax liabilities with the hypothetical tax liability if the employee worked in the United States. The difference between these amounts is then reconciled with the amounts advanced or deducted resulting in a net amount owing by, or due to, the Company.

Expatriate employees must agree to have the professional services firm prepare their individual income tax returns. The Company pays the entire fee for tax preparation services except in circumstances where the employee has non-Company source income requiring significant additional tax preparation services by the professional services firm.

LAW AND ANALYSIS

Section 61(a) of the Code defines "gross income" as, unless otherwise excluded, all income from whatever source derived, including (but not limited to) compensation for services such as fees, commissions, fringe benefits, and similar items. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income derived in any form, whether in money, property, or services. Section 1.61-21(a)(1) of the regulations provides that a fringe benefit may include, for example, an employer-provided discount on property or services.

Section 1.61-21(b) of the regulations provides that an employee must include in gross income the amount by which the fair market value of an item exceeds the amount, if any, paid for the benefit by or on behalf of the recipient. Under section

1.61-21(b)(2), the fair market value of a benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction.

Section 132(a)(3) of the Code excludes from gross income any fringe benefit that qualifies as a working condition fringe. Section 132(d) defines the term "working condition fringe" as any property or services provided by an employer to an employee to the extent that, if the employee paid for the property or services, the payment would be allowable as a deduction under section 162 (ordinary and necessary trade or business expenses) or 167 (concerning depreciation).

Section 1.132-5(a)(1)(iii) of the regulations provides that "an amount that would be deductible by an employee under a section other than section 162 or 167, such as section 212, is not a working condition fringe." (Emphasis added).

Section 212 allows a deduction for nontrade or nonbusiness expenses incurred during the taxable year for the production or collection of income or for the management, conservation or maintenance of property held for the production of income (such as rental property, or investments held for their income and appreciation value). In addition, section 212(3) of the Code provides that, in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. Section 1.212-1(l) of the regulations provides that expenses paid or incurred by an individual "for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns . . ." are deductible.

Revenue Ruling 73-13, 1973-1 C.B. 42, held that fees paid by a corporation for financial counseling services and tax return preparation services provided to its executives are includible in gross income and wages, but are deductible by the executives under section 212 of the Code.

Revenue Ruling 92-29, 1992-1 C.B. 20, considers whether tax preparation fees incurred by a sole proprietor are deductible on Schedule A of Form 1040 as a miscellaneous itemized deduction, or whether these expenses are deductible in determining adjusted gross income (on Schedule C, Profit of Loss from Business) as a trade or business expense.[1] Under the facts of the ruling, the individual pays $500 to a tax return preparer. Of the $500, $200 is properly allocable to preparing the Schedule C, with the remaining $300 properly allocable to preparing the rest of

[1]Section 62(a) of the Code provides that "adjusted gross income" means, in the case of an individual, gross income minus specified deductions. Under section 62(a)(1), one of the specified deductions is any deduction attributable to a trade or business carried on by the taxpayer, provided that the trade or business does not consist of the performance of services by that taxpayer as an employee.

the individual's federal income tax return. The ruling holds that the $200 expense for preparing Schedule C is deductible in computing adjusted gross income, whereas the remaining $300 is deductible under section 212(3) as a miscellaneous itemized deduction.

Because tax return preparation fees are deductible under section 212(3), and not under section 162, employer-provided tax return preparation services are not excludable as a working condition fringe.

The Company has cited Revenue Ruling 92-69, 1992-2 C.B. 51, as authority for excluding the value of the tax preparation services from gross income. The Company's reliance on Rev. Rul. 92-69 is misplaced. In order for employer-provided property or services to qualify as a working condition fringe, section 1.132-5(a)(2)(i) of the regulations requires that a hypothetical payment by the employee for the property or services be allowable as a deduction under section 162 with respect to the employee's specific trade or business of being an employee of the employer; thus, not all expenses deductible by the employee under section 162 will meet this standard. See the examples at regulations section 1.132-5(a)(2)(ii). Rev. Rul. 92-69 provides that this requirement is generally satisfied if, under all the facts and circumstances, (1) the employer derives a substantial business benefit from the provision of the property or services that is distinct from the benefit that it would derive from the mere payment of additional compensation, and (2) the employee's hypothetical payment for the property or services would otherwise be allowable as a deduction by the employee under section 162 of the Code.

Employer-provided tax preparation services fail both requirements set forth in the revenue ruling. Under section 6012(a), every individual is required to file an individual federal income tax return yearly. The inherently personal nature of expenses incurred for individual income tax return preparation is reflected in the fact that these expenses are deductible under section 212(3), not under section 162. The primary benefit of the tax preparation services thus inures to the expatriate employees, not to the Company. Although every employer presumably prefers that its employees follow the tax laws in the United States and abroad, meeting or failing to meet these requirements primarily affects the employee, and any affect on the employer is very remote and insubstantial. The Company could inspect the expatriate employees' filed returns in order to determine the appropriate cost equalization adjustment without paying for tax return preparation. Thus, the provision of tax preparation services does not provide an employer with a benefit that is substantial and distinct from the business benefit the employer would enjoy by providing additional compensation.

Gotcher v. Commissioner, 401 F.2d 118 (5th Cir. 1968), is also cited in asserting that the value of tax return preparation services is not includible in the expatriate employees' gross incomes. Gotcher considered whether a taxpayer must include in income the value of a trip to Germany provided as an incentive to encourage the

taxpayer to purchase an interest in a Volkswagen dealership. The trip cost $1,372.30, of which, $343.73 was paid for by the taxpayer's employer, with the remaining cost shared by Volkswagen of America (VOA) and Volkswagen of Germany (VOG). Before the trip, the taxpayer was offered an ownership interest in the Volkswagen dealership at which he was employed. Upon returning from the trip, the taxpayer bought an ownership interest in the dealership.

The court stated that whether an individual has income within the meaning of section 61 depends upon whether there has been economic gain. The court noted initially that there was no evidence that the trip was awarded in connection with Mr. Gotcher's services as an employee since he was not an employee of VOG or VOA and the trip was not earned in connection with his duties with the dealership. The court distinguished two of its earlier-decided cases, Rudolph v. United States, 291 F.2d 841 (1961), and Patterson v. Thomas, 289 F.2d 108 (1961), in which it concluded that the value of trips provided to employees was includible in gross income because those trips were awarded for past service. Considering the purpose for the trip to Germany, and noting that the objective was ultimately achieved, the court concluded that the primary purpose of the trip was to persuade Mr. Gotcher to take out a VW ownership interest.

The court thus narrowed the issue to determining the tax consequences that follow when a trip provided to an individual primarily benefits the party paying for the trip. The court concluded that the cost of the trip was not gross income to the taxpayer. In so concluding, the court drew an analogy to section 119 of the Code, which excludes the value of meals and lodging furnished for the convenience of the employer from gross income. The court took comfort in the fact that this exclusion was recognized by courts prior to the enactment of section 119. In addition, the court analogized the facts before it to cases where employees were provided benefits that were incidental to the purpose of carrying on the employer's trade or business. The court discussed Allen J. McDowell, 26 T.C. Memo 1967-18, in which an employee was not required to include the value of a trip to Hawaii in income because the taxpayer was required by his employer to go on the trip and the employee was serving a legitimate business purpose of his employer. The court found that Allen J. McDowell stood for the proposition that income does not arise when an individual is serving the legitimate business purposes of the party paying the expense. The court concluded that business realities required that Mr. Gotcher go on the trip to Germany and that the primary purpose of the trip was to serve VW's business interests of improving its position in the American market and finding investors.

We believe that reliance on Gotcher is also misplaced. The Deficit Reduction Act of 1984 (DEFRA '84) enacted a comprehensive scheme dealing with employer-provided fringe benefits, and thus largely supersedes earlier-decided case law on employer-provided fringe benefits. DEFRA '84 incorporated principles that had developed under the common law before 1984, including the principles discussed in Gotcher.

Deficit Reduction Act of 1984

On July 18, 1984, Congress enacted section 531 of DEFRA '84 amending section 61(a) to include "fringe benefits" in the definition of gross income and adding section 132 to exclude certain fringe benefits from gross income.[2] DEFRA '84 also provided the Treasury Department with the specific authority to promulgate any regulations necessary to carry out the purposes of section 132. Section 132 substituted a statutory approach for the prior common law approach in determining whether employer-provided fringe benefits are excluded from gross income. The prior common law approach generally looked to whether the fringe benefit was compensatory or noncompensatory. Consequently, effective January 1, 1985, any fringe benefit is includible in the recipient's gross income unless the fringe benefit is excluded from gross income by a specific statutory provision.

The House Report to DEFRA '84 indicates Congress' intent that the new rules provide certainty with respect to the taxation of employer-provided fringe benefits.

> The second objective of the committee's bill is to set forth clear boundaries for the provision of tax-free benefits. Because of the moratorium on the issuance of fringe benefit regulations, the Treasury Department has been precluded from clarifying the tax treatment of many of the forms of noncash compensation commonly in use. As a result, the administrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the IRS resulting from this situation have increased substantially in recent years. The Congress

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[2]The enactment of DEFRA was preceded by a moratorium first enacted in 1978 prohibiting issuance of Treasury regulations relating to the income tax treatment of nonstatutory fringe benefits. Public Law 95-427 prohibited the Treasury Department from issuing, prior to 1980, final regulations under section 61 relating to the income tax treatment of fringe benefits. The statute further prohibited Treasury from proposing regulations relating to the treatment of fringe benefits under section 61 which would be effective prior to 1980. Public Law 96-167, enacted in 1979, extended the moratorium on issuance of fringe benefit regulations through May 31, 1981. The Economic Recovery Tax Act of 1981 (Public Law 97-34) extended the moratorium on issuance of fringe benefit regulations through December 31, 1983. Through various pronouncements Congress indicated its belief that a proper review of the important issues involved in the income and employment tax treatment of nonstatutory fringe benefits would require an additional period of time. Consequently, Treasury announced that it "will not issue any regulations or rulings altering the tax treatment of nonstatutory fringe benefits prior to January 1, 1985," and that "present administrative practice will not be changed during this period" (Ann. 84-5, 1984-4 I.R.B. 31).

> believed that it would be unacceptable to allow these conditions–which had existed since 1978–to continue any longer.
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> In addition, the committee is concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash.

H.R. Rep. No. 432, Part II, 98th Cong. 2nd Sess. 1591-92 (1984). See also Staff of the Joint Comm. on Taxation, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 840-841 (JCS-41-84).

The Conference Report also indicates Congress' intent to create certainty by providing clear rules.

> [T]he conference agreement sets forth statutory provisions under which (1) certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA, and (2) any fringe benefit that does not qualify for exclusion under the bill and that is not excluded under another statutory fringe benefit provision of the Code is includible in gross income for income tax purposes, and in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit. The latter rule is confirmed by clarifying amendments to Code sections 61(a), 3121(a), 3306(b), and 3401(a) and section 209 of the Social Security Act. (Emphasis added).

H. R. Conf. Rep. No. 861, 98th Cong., 2nd Sess. 1169 (1984), 1984-3 (Vol. 2) C.B. 1, 423; see also H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1593, 1609 (1984); Staff of the Joint Comm. on Taxation, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 843 (JCS-41-84).

Thus, DEFRA '84 was enacted by Congress to provide statutory rules for the income and employment tax treatment of fringe benefits provided by an employer to an employee. In accordance with this specific legislative action any fringe benefit is includible in the recipient's gross income for income tax purposes unless the fringe benefit is excludable from gross income under a specific statutory provision.

The Gotcher decision incorporates principles that had developed under the common law before DEFRA '84 with respect to employer-provided fringe benefits. These principles have been embodied in the section 61/section 132 regime. For example, in the first instance, we look to whether the fringe benefit is provided in

connection with an employment relationship. See section 1.61-21(a)(3) of the regulations. In addition, in the case of an employer-provided trip, under section 132(d), the determination must be made whether the cost of the trip would be deductible by the employee under section 162 as an expense incurred in connection with the employee's employment with the employer. This test is akin to determining whether the benefit was provided with the primary purpose of benefitting the employer's trade or business, as opposed to merely providing the benefit to the employee as additional compensation. Thus, the Code and regulations reflect the principle discussed in Gotcher that fringe benefits (such as a business trip) provided primarily to serve a business purpose of the employer are excludable from gross income.[3]

Fringe benefits that an employer "requires" its employees to accept are not automatically excludable from gross income; rather, the nature of the hypothetical expense determines deductibility under section 162. Benefits provided to an employee for the purpose of carrying on the employer's trade or business would often times be required in connection with an employee's job duties, and thus would be deductible by the employee under section 162 if incurred by the employee. But "requiring" that an employee accept any benefit does not automatically transform an otherwise nondeductible item, or an item deductible only under section 212, into an expense deductible under section 162.

As stated, these rules clearly provide that tax preparation fees deductible under section 212(3) are not excludable under section 132(a)(3) and 132(d) as a working condition fringe. Thus, the value of these fringe benefits is includible in gross income.

Under regulations section 1.61-21(b)(2), the value of the tax return preparation services is the amount that the employee would have had to pay for the tax preparation services if the employee had paid the professional services firm for the services in an arm's length transaction. The value of the services provided to the Company for the specific purpose of calculating the amount owing by, or due to, the Company to equalize the income tax costs of its expatriate employees is excludable as a working condition fringe.

In conclusion, we emphasize that Congress intended to provide clear rules regarding employer-provided fringe benefits. We are wary of attempts to revive pre-DEFRA '84 case law in an effort to create confusion and uncertainty in areas where the Code and the Treasury regulations provide clear rules. We conclude

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[3]Indeed, assuming for the sake of argument that Gotcher still has some vitality, its reasoning suggests that the value of employer-provided tax preparation services is includible in gross income. The tax preparation services are provided in connection with an employee's employment. In addition, the services satisfy a personal duty of the employee, and only remotely benefit the employer's trade or business.

therefore that the value of individual tax preparation services may not be excludable from gross income as a working condition fringe.[4]

Issue 2. Whether the value of the tax return preparation services provided to an employee by an employer is wages for employment tax purposes.

FICA tax

Sections 3101, 3102(a), and 3111 of the Code provide that every employer making payments of wages is required to withhold and pay FICA taxes.

Section 3121(a) of the Code provides that, for FICA purposes, the term "wages" means all remuneration for employment unless otherwise excepted.

Section 3121(b) of the Code defines "employment," in pertinent part, as including any service, of whatever nature, by an employee for the person employing him, irrespective of the citizenship or residence of either, within the United States; and service performed outside the United States by a United States citizen or resident as an employee of an American employer (as defined in section 3121(h)).

Section 3121(h) of the Code defines "American employer" as the United States or an instrumentality thereof; a United States resident; a partnership, two-thirds or more of the partners of which are United States residents; a trust, if all the trustees are United States residents; and a corporation organized under the laws of the United States or of any state.

Section 3121(a)(20) of the Code provides that, for FICA purposes, the term "wages" does not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132. Section 31.3121(a)-1T Q/A-1 of the temporary Employment Tax Regulations provides that fringe benefits are included in the definition of "wages" under section 3121(a) unless specifically excluded from the definition of "wages" pursuant to section 3121(a)(1) through (20).

The law is very clear that the value of the tax return preparation services provided in-kind by an employer to an employee is not excludable as a working condition fringe under sections 132(a)(3) and 132(d). Therefore, it was not reasonable for the Company to believe at the time the fringe benefit was provided that the

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[4]We also note that the Conference Report to the recently enacted Economic Growth and Tax Relief Reconciliation Act of 2001 provides that new sections 132(a)(7) and 132(l), dealing with qualified retirement planning services, specifically do not exclude from gross income the value of tax preparation services. This indicates Congress' intent that employer-provided tax preparation services not be excludable from gross income. See Conference Report to H.R. 1836, page 188.

employee receiving the benefit would be able to exclude the benefit from gross income under section 132.

Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978) does not change this result. In Central Illinois, the Court stated, "Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative." 435 U.S. at 35. Section 132(d) and the regulations thereunder provided the Company with clear notice of its obligation to withhold.[5] See American Airlines, Inc. v. United States, 204 F.3d 1103, 1113 (Fed. Cir. 2000) (finding that section 132(e) and the regulations thereunder, dealing with de minimis fringes, provided the employer with sufficient notice of its obligation to withhold and pay employment taxes).

FUTA tax

Section 3301 of the Code imposes an excise tax on every employer with respect to wages paid by him with respect to employment (FUTA tax).

Section 3306(b) of the Code defines "wages," with certain exceptions, as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

Section 3306(c) of the Code defines "employment," in pertinent part, as including any service, of whatever nature, performed by an employee for the person employing him, irrespective of the citizenship or residence of either, within the United States; and any service, of whatever nature, performed after 1971 outside the United States (except in a contiguous country with which the United States has

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[5]The legislative history also indicates Congress' intent to provide clear rules with respect to the employment tax treatment of fringe benefits.

> Since the statutory term 'remuneration' is to be interpreted broadly to include compensation for services which have been performed, noncash benefits (such as allowances for meals when the employee is not away from home overnight) which are not excluded under the provisions of this bill or other statutory provisions are to be subject to these employment taxes. This broad interpretation of remuneration is especially important in the case of FICA, for which withholding is generally the only collection method available.

H.R. Rep. No. 432, part II, 98th Cong., 2nd Sess. 1609 (1984); see also Staff of the Joint Comm. on Taxation, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 865 (JCS-41-84).

an agreement relating to unemployment compensation) by a citizen of the United States as an employee of an American employer.

Section 3306(b)(16) provides that for purposes of FUTA tax, the term "wages" does not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132.

As discussed, it was not reasonable at the time the benefit was provided for the Company to believe the value of the tax preparation services would be excludable from the employee's gross income. Therefore, the value of these services is wages subject to FUTA tax (subject, of course, to the FUTA tax wage base limitation).

Federal Income Tax Withholding

Under section 3402(a)(1) of the Code, with certain exceptions, every employer making payment of "wages" is required to deduct and withhold upon those wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary.

For income tax withholding purposes, section 3401(a) of the Code defines "wages," with certain exceptions, as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.

Section 3401(a)(19) of the Code provides the term "wages" does not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132.

For the reasons discussed above, the value of income tax preparation services provided to expatriate employees is not excludable from gross income based upon section 3401(a)(19) of the Code.

However, section 3401(a)(8)(A)(i) of the Code excepts from the definition of wages remuneration for services performed by a citizen of the United States outside the United States if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excludable from gross income under section 911 of the Code.[6]

Section 31.3401(a)(8)(A)-1(a)(1)(i) of the regulations provides that the employer's belief that section 911 applies need only be based upon evidence reasonably

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[6]For 2001, $78,000 of income meeting the definition of "foreign earned income" may be excluded from gross income. Code § 911(b)(2).

sufficient to induce such belief, even though the evidence is later determined by the Service or a court to be insufficient to support an exclusion under section 911. However, the reasonable belief must be based upon the application of section 911 and the regulations thereunder.

Thus, the value of the tax return preparation services may be excludable from wages for income tax withholding purposes if the employer had a reasonable belief, based upon contemporaneous information, that the value of the fringe benefit provided by it would be excludable from the employee's gross income under section 911.

Please call if you have any further questions.

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