DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Chief, Branch 2 (Employee Benefits and Exempt Organizations)

SUBJECT: State Legislators' Business Expenses

Legend

State =

This is response to your request that we review your memorandum concerning whether members of State's legislature may deduct their employee business expenses "above-the line" in accordance with section 62(a)(2)(C) of the Internal Revenue Code (the "Code").

Conclusion

It is our view that the legislators are not compensated in whole or in part with a "fee" for purposes of I.R.C. § 62(a)(2)(C). Accordingly, they are not allowed to deduct their unreimbursed employee business expenses above the line.

Facts & Issue

As we understand the facts, State legislators may incur expenses in connection with their duties that are not reimbursed by the state. This raises the issue of whether those expenses are deductible only as miscellaneous itemized deductions on Schedule A, subject to the 2% floor imposed by I.R.C. § 67 or are fully deductible because the legislators are eligible for the I.R.C. § 62(a)(2)(C).

Applicable Law

Section 62(a)(2)(C) was added to the Code by Section 975 of the Taxpayer Relief Act of 1997. As stated in your memorandum, I.R.C. § 62(a)(2)(C) provides that adjusted gross income is computed by subtracting from gross income

> deductions allowed by section 162 which consist of expenses paid or incurred with respect to services performed by an official as an employee of a State or a political subdivision thereof in a position **compensated in whole or in part on a fee basis**. (*emphasis added*).

The effect of I.R.C. § 62(a)(2)(C) is that public officials compensated with fees ("fee basis public officials") may deduct unreimbursed employee business expenses above the line, that is, without regard to the two percent floor imposed by I.R.C. § 67. In the legislative history to the enactment of I.R.C. § 62(a)(2)(C) Congress articulated the following as reasons for the change:

> The Congress was aware that certain state and local government officials are compensated (in whole or in part) on a fee basis to provide certain services to the government. These officials hire employees and incur expenses in connection with their official duties. These expenses may be subject, under prior law, to the two percent floor on itemized deductions. The Congress believed these expenses should be deductible.
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> Congress then explained the new provisions as follows:
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> Under the Act, employee business expenses relating to service as an official of a state of local government (or political subdivision thereof) are deductible in computing AGI ("above the line"), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for minimum tax purpose.

Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (Comm. Print 23-97) (The Blue Book) pp. 66-67.

As enacted, I.R.C. § 62(a)(2)(C) applies to public officials compensated in whole or in part with fees. Accordingly, we must determine whether the State legislators are compensated with fees.

Analysis

The legislative history confirms that Congress intended this provision to apply to fee basis public officials, not to all public officials or public employees. In addition, it is significant that the legislative history does not suggest that the terms "fee basis" be defined other than as previously defined in Internal Revenue Service guidance for other Code provisions. Congress did not, for example,

indicate that the definition of "fee" under relevant state law would apply for this purpose.

The phrase "fee basis public official" is not defined in the Code or the regulations. However, prior to the enactment of I.R.C. § 62(a)(2)(C), whether a public official was a fee basis official was relevant for determining whether the official was subject to Self-Employment Contributions Act (SECA) taxes on amounts received for the performance of services as a public official. As discussed herein, the IRS has issued guidance for this purpose.

SECA taxes are imposed pursuant to I.R.C. §§ 1401 and 1402 on the gross income, less applicable deductions, derived by an individual from any trade or business. For SECA purposes the term "trade or business" has the same meaning as when used in I.R.C. § 162 (relating to trade or business expenses), with certain exceptions. Section § 1402(c)(1) provides that the performance of the functions of a public office is not a trade or business for SECA purposes. However, an exception to this general rule is set forth in I.R.C. § 1402(c)(1) and Treas Reg. § 1.1402(c)-2(a)(2)(b). The exception provides that the performance of the functions of a public office is a trade or business with respect to fees received for functions performed in a position compensated solely on a fee basis but only if the functions are not covered by a Section 218 Agreement.[1]

Thus, amounts paid to public officials either for the performance of the functions of a public office are not subject to SECA unless the functions or services are performed in a position compensated solely by fees that is not covered by a Section 218 Agreement. Thus, to determine whether the public official was subject to SECA, it was necessary to define the terms fee and position.

Unlike, I.R.C. § 1402(c)(1), I.R.C. § 62(a)(2)(C) does not require the public official to be in a position compensated solely with fees, making it unnecessary to define position. However, the term fee must be defined. Revenue Ruling 74-608, 1974-2 C.B. 275 addresses the meaning of "fee". This ruling concerns an individual elected to collect the county, township, and school district taxes within the individual's electoral district. The individual accounted for and turned over all collections to the treasurer of each taxing authority and was compensated from state funds on the basis of a fixed percentage of each tax. The ruling holds that when an elected official receives his remuneration in the form of fees directly from the members of the public with whom he does business, the remuneration is "fees" within the meaning of I.R.C. § 1402(c)(1). When, however, a public official receives

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[1]Section 218 of the Social Security Act was enacted in 1950. It permits states to enter into an agreement with the Social Security Administration to provide social security coverage to state and local government employees. This agreement is commonly called a "Section 218 Agreement."

his remuneration or salary from a government fund and no portion of the monies collected by him belongs to or can be retained by him as compensation, the remuneration is not "fees" under I.R.C. § 1402(c)(1). Thus, the IRS position focuses on the source of the payments.

The IRS position was adopted by the Social Security Administration in SSA Information Release No. 108, December 31, 1991. Social Security agreed to adopt the IRS position due in part to the confusion among local employing entities concerning whether a payment was a fee for tax liability and social security coverage. (A copy of SSA Information Release No. 108 is enclosed.)

We see no reason for adopting a different definition of fee for purposes of I.R.C.§ 62(a)(2)(C) and do not believe this position takes an overly restrictive view of the changes intended by Congress. Rather this position allows the provision to be utilized only by true fee basis public officials, and it does not invite the state and local governments to recast compensation as "fees." There are many state and local officials such as clerks of court, justices of the peace and certain judges who are compensated in whole or in part on a fee basis, as described in Rev. Rul.74-608, and would be eligible to use I.R.C. § 62(a)(2)(C).

Finally, your memo concludes that it is not necessary for a legislator to make an election under I.R.C. § 162(h) to take deductions above the line. Although it is our conclusion that the state legislators are not eligible for I.R.C. § 62(a)(2)(C), and it may be that generally legislators are not fee basis public officials, we agree that a fee basis public official who is eligible for I.R.C. § 62(a)(2)(C) need not make an election under I.R.C. § 162(h). The two sections are not interrelated.

If you have any questions, please call me at (202) 622-6040.

JERRY E. HOLMES

Enclosure