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August 11, 2006

Legend:
Country X:
Agency Y:

Dear :

This letter responds to your request for information dated August 25, 2005. You asked how the United States tax system treats certain payments made by Agency Y in Country X to locally-resident U.S.-citizen employees under the Local Compensation Plan (LCP Employees).

The Country X social welfare system (SWS) is a compulsory system. The SWS provides for various forms of insurance coverage. These are described as health insurance, long-term care (or nursing) insurance, accident insurance, unemployment insurance, and pension insurance[1] (the Insurance Funds).

The funding mechanism for the SWS is a tax on the compensation of workers. Generally, this tax is levied equally on employers and employees as a percentage of compensation. Accordingly, this tax requires an employer contribution to the SWS and an employee contribution to the SWS. Generally, it is the responsibility of the employer to deduct from the employee's compensation the employee's SWS contribution and

[1] The facts that we were provided indicate that under the bilateral totalization agreement between Country X and the United States, LCP Employees could elect to participate in the Country X retirement system by making payments into the pension insurance fund. However, no LCP Employees have elected to participate in the Country X retirement system.

then remit this amount, along with the employer's SWS contribution, to the appropriate office.

The employer and employee contributions are used to finance the Insurance Funds. Specifically, the law requires that both the employer and employee contribute to the health insurance fund, the long-term care insurance fund, the pension insurance fund and the unemployment insurance fund. Only employers contribute to the accident insurance fund.

Country X employment laws dictate that an employee is allowed to choose a health insurance carrier. The employer contribution and the employee contribution to the Insurance Funds are remitted to the health insurance carrier. The health insurance carrier retains the contributions for health insurance. The health insurance carrier forwards the remaining contributions to the appropriate offices. Employers remit the employer accident insurance fund contributions directly to the Country X worker's compensation office.

Country X has over 200 national health insurance carriers. As noted above, each employee may choose to be covered by any carrier. Agency Y has determined that it is not administratively practical to establish multiple remittance obligations with the various possible health insurance providers.

In order to reduce administrative burden, Agency Y basically requires that the LCP Employees act as SWS self-payers. In addition to normal pay and allowances, an amount equal to the required employer contribution to the health insurance fund, the long-term care insurance fund, the pension insurance fund (if applicable) and the unemployment insurance fund is included in the paycheck of the LCP Employees (the SWS Employer Contribution). The LCP Employees combine the SWS Employer Contribution with an amount equal to the required employee contribution to the health insurance fund, the long-term care insurance fund, the pension insurance fund (if applicable) and the unemployment insurance fund and remit this combined amount to the health insurance carrier of their choosing. Agency Y remits the employer accident insurance fund contributions directly to the Country X worker's compensation office.

You have asked us to consider whether the SWS Employer Contributions are wages subject to income tax withholding.

For income tax withholding purposes, Code section 3401(a) provides that the term "wages" includes all remuneration, in whatever form, for employment unless a specific exception applies. Code section 3402(a) provides that each employer making a payment of wages is required to deduct, withhold and pay over to the government the appropriate amount of income tax with respect to those wages. Employment Tax Regulation section 31.3402(a)-1(b) provides that the employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, actually or constructively.

Code section 106 and Income Tax Regulation section 1.106-1 provide that gross income of an employee does not include contributions by the employer to accident or health plans for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse, or the employee's dependents. Rev. Rul. 56-632, 1956-2 C.B. 101, holds that benefits excluded under Code section 106 are not subject to income tax withholding.

Rev. Rul. 57-33, 1957-1 C.B. 303, holds that certain payments made by employers directly to employees pursuant to a union contract of employment, for the purpose of purchasing individual hospitalization and surgical insurance coverage, are wages subject to income tax withholding. In that Revenue Ruling, when member employers had no existing company program to cover their employees, the union assumed the responsibility of making sure that its members spent the weekly payment for such benefits. The union had made direct arrangements with a hospital service for this purpose and in no instance were the payments under the contract being made or used for a purpose other than providing the hospitalization and surgical insurance benefits. Nevertheless the Revenue Ruling found it immaterial that the union assumed the responsibility for the employees' disposition of such payments and the purchase of hospitalization and surgical insurance. The payments were required under the terms of a labor agreement, were directly related to the units of service performed by the employees, and were paid directly to the employees by the employers. Thus, they were a basic part of the compensation of each employee involved.

Rev. Rul. 61-146, 1961-2 C.B. 25, considered a situation in which employees not covered by an employer's group policy were covered under other types of hospital and medical insurance for which the employees paid premiums directly to the insurers and were reimbursed by the employer. The employer required proof that the insurance was in force for the employee and that premiums for the period involved had been paid by the employee. The employer's payment was stated to be in reimbursement for the employer's share of the insurance premiums. Revenue Ruling 61-146 concluded that such reimbursements constituted employer payments of accident or health insurance premiums for employees and therefore were excludable from the gross income of the employees under section 106 of the Code. Rev. Rul. 57-33 was distinguished because in that case the employers had no accident or health plan of their own in effect, and, with respect to the payments that they made directly to the employees, they did not require an accounting either by the employees or the employees' union that the funds were expended in the acquisition of insurance coverage.

In Rev. Rul. 75-241, 1975-1 C.B. 316, a contractor performing a service contract for the United States Government was required by law to pay health and welfare benefits to his employees on a parity with those prevailing in the locality where the services were performed, or, at the contractor's election, to discharge this obligation by paying a cash amount to his employees in lieu of the specified health and welfare benefits. The

contractor elected to make cash payments to the employees. The Ruling states that, since the contractor had no legal or contractual obligation to verify, and did not verify, that the cash payments were used by the employees to purchase health and welfare benefits, the employees had complete control of the disposition of the funds. Thus, the payments were attributable to services performed by the employees for their employer, although the employer paid the amounts in discharge of a requirement of a Federal statute that minimum fringe benefits in the form of health and welfare benefits be provided. The Revenue Ruling concluded that the payments were wages for income tax withholding purposes and were includible in gross income.

Accordingly, these Revenue Rulings demonstrate that, absent a reimbursement arrangement or system of accounting, amounts provided by an employer to an employee for the purpose of paying for insurance such as health insurance or long-term care insurance are wages subject to income tax withholding and included in gross income. Conversely, accident insurance premiums that an employer pays directly to a carrier would generally be excluded from the gross income and wages of the employee.

Further, the definition of the term wages provided in Code section 3401(a) does not include an exception for amounts provided by an employer to an employee which the employee uses to pay for unemployment insurance.

Finally, with respect to an LCP Employee electing to participate in the Country X retirement system by making payments into the pension insurance fund, as we noted above, Employment Tax Regulation section 31.3402(a)-1(b) requires an employer to withhold income taxes on wages when actually or constructively paid. It is our view that, as a threshold matter, the question of whether an employee is in actual receipt of wages arises when an employer provides amounts directly to an employee for the purpose of making contributions into a pension insurance fund. Whether the terms of the totalization agreement between the United States and Country X, the terms of the income tax treaty between the United States and Country X, and the various Code provision which relate to arrangements between an employer and employee to defer compensation could impact the application of Employment Tax Regulation section 31.3402(a)-1(b) is beyond the scope of this general information letter.

The interpretation of foreign law is an area in which the Internal Revenue Service does not ordinarily issue rulings. See Rev. Proc 2006-7, section 4.02, 2006-1 IRB 244 (Jan. 3, 2006). The facts as stated above represent our understanding of your description of the laws of County X. Nothing in this letter is an interpretation of foreign law.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2006-1, section 2.04, 2006-1 IRB 7 (Jan. 3, 2006). I hope that this information is

helpful and that our delay in responding has not caused you any inconvenience. If you have any additional questions, please contact our office at .

Sincerely,

Dan E. Boeskin
Assistant Branch Chief, Employment Tax Branch 1
(Exempt Organizations/Employment Tax/Government Entities)
(Tax Exempt & Government Entities)