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Department of the Treasury

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CC:ITA:2 – PLR-118495-00
Date: April 10, 2001

In Re:

LEGEND:

H =

W =

State =

X =

Dear :

This letter is in response to your request for a private letter ruling concerning the application of § 265(a)(1) of the Internal Revenue Code to deductions claimed by H and W for home mortgage interest, State income taxes, real property taxes, and investment interest.

FACTS:

You represent that H and W are married individuals who file joint income tax returns. H is a foreign national and a resident alien of the United States. H is employed by X, an international organization, whose Articles of Agreement provide that no tax shall be levied on salaries or emoluments paid to foreign nationals. H's salaries and emoluments ("Compensation") consist of three elements: (i) salary, (ii) a Spouse and Child Allowance, and (iii) a Home Leave Allowance. The Spouse and Child Allowance is designed to provide a benefit in the form of increased salary that is roughly equivalent to the benefits a married employee of X whose salary is subject to federal income tax receives in the forms of a lower tax rate for such individual (as compared to his or her single counterpart), and of personal exemptions for children and other dependents. The Home Leave Allowance is a payment to defray the costs (mainly transportation costs) incurred by foreign employees of returning to their home countries to renew family and cultural ties. In addition, H's Compensation is not subject to State income

tax. H does not maintain an office in the home for the purpose of performing work for X.

W is a citizen of the United States and works part time. H and W also earned interest and dividend income.

RULING REQUESTED

You have requested that we rule that § 265(a)(1) does not disallow H and W's otherwise allowable itemized deductions for mortgage interest expense, State income tax, real property taxes, and investment interest expense because they are not "allocable to" H's tax-exempt Compensation from X within the meaning of § 265(a)(1).

LAW AND ANALYSIS:

Section 893(a) of the Code provides in part that wages or salary of any employee of an international organization received as compensation for official services shall not be included in gross income and shall be exempt from taxation if such employee is not a citizen of the United States.

Section 1.893-1(b)(4) of the Income Tax Regulations provides that an employee of an international organization who executes and files with the Attorney General the waiver provided for in § 247(b) of the Immigration and Nationality Act (8 U.S.C. § 1257(b)) thereby waives the exemption conferred by § 893.

However, under § 1.893-1(c)(2), if an international agreement provides that compensation paid by the international organization to its employees is exempt from the federal income tax, and the application of the exemption is not dependent upon the provisions of the internal revenue laws, the exemption so conferred is not affected by the execution and filing of a waiver under § 247(b) of the Immigration and Nationality Act. See Rev. Rul. 75-425, 1975-2 C.B. 291.

The Articles of Agreement of X provides that no tax shall be levied on or in respect of salaries and emoluments paid to employees who are not local citizens, local subjects, or other local nationals. This organization is listed in part 4 of Rev. Rul. 75-425 as an international organization whose exemption is not terminated by the filing of the waiver provided by § 247(b) of the Immigration and Nationality Act.

Section 265(a)(1) provides that no deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class is received or accrued) wholly exempt from the taxes imposed by this subtitle.

Section 1.265-1(c) provides that expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or an amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

Rev. Rul. 83-3, 1983-1 C.B. 72, modified by Rev. Rul. 87-32, 1987-1 C.B. 131, states that the purpose of § 265 is to prevent a double tax benefit. Applying this principle, the ruling reasons that § 265 applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income, or when tax-exempt income is earmarked for a specific purpose and deductions are incurred in carrying on that purpose. Situations 1 and 3 of the ruling address the application of § 265 to taxpayer-attorneys who used the proceeds of scholarships that were excludable from gross income to pay, in part, for courses they took as a condition of continued employment. The ruling concludes that because the taxpayers incurred expenses for the purposes for which the tax-exempt income was received, they must decrease the deductible amount of their educational expenses because a portion of those expenses was allocable to the scholarships.

In Banks v. Commissioner, 17 T.C. 1386 (1952), the court held that no deduction could be taken for educational expenses paid by a tax-exempt grant from the Veterans' Administration. Similarly, in Manocchio v. Commissioner, 78 T.C. 989 (1982)*, aff'd on other grounds,* 710 F.2d 1400 (9th Cir. 1983), the court ruled that a pilot could not deduct the cost of a flight training course to the extent those expenses were reimbursed by the Veterans' Administration. The Tax Court noted that the "fundamental nexus between the reimbursement and the expense" fell within "the scope of any reasonable interpretation of the 'allocable to' requirement." Manocchio, 78 T.C. at 995.

In Induni v. Commissioner, 990 F.2d 53 (2nd Cir. 1993), the taxpayer received a tax-exempt Living Quarter's Allowance (LQA) from the United States government while working for the Immigration and Naturalization Service in Canada. The court held that the taxpayer's mortgage interest and real estate tax deductions were allocable to the LQA because these were the housing expenses intended to be covered by the LQA. Accordingly the portion of these expenses allocable to the tax-exempt income was disallowed pursuant to § 265(a)(1).

In Lapin v. United States, 655 F. Supp.1344 (D. Hawaii 1987), the court held that the portion of state income tax paid on a cost of living adjustment ("COLA") that was exempt from federal income tax but not state income tax was directly allocable to the COLA and no other category of income. Thus, § 265 disallowed a deduction for that portion of the taxpayer's state income taxes. See also Rev. Rul. 74-140, 1974-1 C.B. 50.

In this case, H does not maintain a home office related to his employment with X. Thus, H and W's expenses for mortgage interest and real property taxes on their home are not used to produce the tax-exempt Compensation H receives from X. In addition, the Compensation that H receives from X is not earmarked for housing expenses, unlike the situation described in Induni. Thus, H and W's expenses for mortgage interest and real property taxes on their residence are not allocable to H's Compensation under § 265(a)(1).

In addition, because H's Compensation is not subject to State income taxes, the State income taxes that H and W pay are not allocable to the Compensation under § 265(a)(1). Thus, this situation is unlike that described in Lapin and Rev. Rul. 74-140.

Further, the investment interest paid by H and W is not used to produce H's Compensation and the Compensation is not earmarked for the payment of investment interest. Thus, H and W's investment interest expense is not allocable to H's Compensation under § 265(a)(1).

CONCLUSION:

H and W's otherwise allowable deductions for mortgage interest expense, real estate taxes, State income tax, and investment interest expense are not allocable to H's Compensation. Thus, the deductions for such expenses are not disallowed under § 265(a)(1) as a result of H's receipt of the Compensation from X.

CAVEATS:

Except as expressly provided in the preceding paragraph, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. Thus, no ruling is requested, and no opinion is expressed regarding whether the deduction provided under § 152 is allocable to the Spouse and Child Allowance under § 265(a)(1). In addition, no opinion is expressed as to the applicability of § 893 to the facts submitted.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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(Income Tax & Accounting)
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