Revision Date: December 3, 2001

COORDINATED ISSUE
SHIPPING AND AIR TRANSPORT INDUSTRIES
FEDERAL INCOME TAX WITHHOLDING ON COMPENSATION PAID TO NONRESIDENT ALIEN CREW MEMBER BY A FOREIGN TRANSPORTATION ENTITY
UIL 3401.01-05
Revised for Years Beginning after December 31, 1997

REVISED:

The coordinated issue paper, "FEDERAL INCOME TAX WITHHOLDING ON COMPENSATION PAID TO NONRESIDENT ALIEN CREW MEMBER BY A FOREIGN TRANSPORTATION ENTITY" issued on July 24, 1995, is being revised to reflect additional support that section 3402(e) does not apply to compensation paid to nonresident alien crew members performing services partly within and partly outside of the United States during a pay period of 31 days or less.

The paper is also being revised as a result of changes made by Section 1174 of The Taxpayer Relief Act of 1997, Public Law 105-34. Section 1174 "treats gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with international operation of a ship as income from foreign sources." Thus, such income is exempt from U.S. income tax and withholding tax effective for taxable years beginning after December 31, 1997.

As Section 1174 applies only to foreign "vessels" and not to foreign "aircraft," the coordinated issue paper will only apply to U.S. sourced compensation paid to nonresident alien crew members of aircraft for taxable years beginning on or after January 1, 1998. However, this paper will continue to apply with respect to nonresident alien crew members of both ships and aircraft for taxable years beginning before January 1, 1998.

ISSUE:

Whether compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the United States on trips between U.S. and foreign destinations should be subject to withholding tax under section 3402 or section 1441.

SUMMARY:

In cases involving international transportation other than transportation to a U.S. possession, foreign

employers paying wages in conjunction with such international transportation should uniformly withhold tax under section 3402 rather than section 1441.

FACTS:

The issue involves foreign corporations that are engaged in a trade or business in the United States through the operation of ships or aircraft. The ships or aircraft typically sail or fly around the world, transporting cargo and/or passengers. This paper only considers the transportation that occurs between the United States and foreign destinations.[1]

Typically, these foreign corporations employ nonresident alien individuals as crew on their vessels or aircraft. Many of these crew employees do not have a U.S. social security number.

LAW:

Applicability of Section 3402:

Under section 3402(a)(1), every employer making payment of wages is required to withhold federal income taxes as provided in the regulations. Under section 3401(d), an employer generally means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. The question under section 3402 is whether the compensation paid to employees who are nonresident alien crew for their services performed within the United States is "wages."

Section 3401(a) generally defines wages as remuneration for services performed by an employee for his employer with certain exceptions. Under section 3401(a)(6), an exception from wages is provided for remuneration paid for such services performed by a nonresident alien individual as may be designated by regulations. Treas. Reg. § 31.3401(a)(6)-1(a) provides that all remuneration paid for services performed by a nonresident alien individual is subject to withholding under section 3402, if such remuneration otherwise constitutes wages and if such remuneration is effectively connected with the conduct of a U.S. trade or business, unless excepted from wages under that section. Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the United States is excepted from wages and hence is not subject to withholding under section 3402. For these purposes, performance of services within U.S. territorial waters is considered within the United States, and performance of services in international waters is

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1 This paper is limited to transportation between United States and foreign destinations (described in section 863(c)(2)(A)), and does not consider transportation that begins and ends in the United States on so-called cruises to nowhere (described in section 863(c)(1)) or transportation to or from a U.S. possession (described in section 863(c)(2)(B)).

considered outside the United States.[2] The crew's performance of services within the United States will necessarily constitute engaging in a U.S. trade or business, and their compensation will be U.S. source income that is effectively connected with a U.S. trade or business.[3] Thus, under this regulation, compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the United States or U.S. territorial waters is wages subject to withholding under section 3402.

Section 3402(e) provides, in pertinent part, that if the remuneration paid by an employer to an employee for services performed during more than one-half of any payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such payroll period shall be deemed wages.[4] As noted, Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the United States is excepted from wages and, hence, is not subject to withholding under section 3402. Since nonresident alien crew members employed on trips between U.S. and foreign destinations provide the greater portion of services outside the United States during any given payroll period, the application of section 3402(e) to nonresident aliens earning compensation for performing services within the United States and outside of the United States, would result in none of the compensation paid the nonresident alien crew as being classified as wages subject to section 3402 withholding. However, the withholding statute should not be applied without consideration of its legislative history and the applicable case law.

In Rev. Rul. 79-318, 1979-2 C.B. 352, the Service considered the application of the included-excluded rule of the FICA to services performed within the United States by Canadian citizen employees working for a Canadian employer. Under the facts of the ruling, in every pay period each employee performed services for less than one-half of the pay period within the United States. The ruling concludes that the included-excluded rule found in section 3121(c) does not apply to this situation. The ruling states that the included-excluded rule in section 3121(c) applies only to services that are performed within the United States or services that are performed without the United States by a United States citizen for an American employer and that the specific exceptions provided in section 3121(b) are used to determine whether amounts are included or excluded.

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2 See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

3 See I.R.C. §§ 864(b) and (c)(2); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the United States, which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

4 Section 3402(e) applies to payrolls of not more than 31 consecutive days. If the payroll period is more than 31 consecutive days, the all-or-nothing rule would not apply and section 3402 withholding is required with respect to that portion of the remuneration that constitutes wages. Treas. Reg. section 31.3402(e)-1(e); see also Rev. Proc. 79-38, 1979-2 C.B. 501 (concerning "end-of-voyage" payroll procedures).

Rev. Rul. 79-318 cites and is based on the facts of *Inter-City Truck Lines, Ltd. v. United States*, 408 F.2d 686 (Ct. Cl. 1969). The court in that case rejected an overly literal reading of section 3121(c), which on its face could have been read as supporting the plaintiff's position. The court examined the legislative history and the "contemporaneous construction" of the provision by the Service.[5] 408 F.2d at 687-688. The court held that the included-excluded rule applies only where the employee is performing both (1) services that fall within the basic definition of employment contained in section 3121(b), and (2) other services that fall within the basic definition of employment contained in section 3121(b) but are excluded by one of the specific enumerated exceptions.

Although Rev. Rul. 79-318 and *Inter-City Truck Lines, Ltd.* provide direct authority for the interpretation of FICA and FUTA included-excluded rules, the wording of the income tax withholding included-excluded rule and the structure of the provisions defining wages under the income tax withholding provisions raise the issue of whether the result should be different under the income tax withholding provisions. In both the FICA and the FUTA, the term "wages" is defined as remuneration for employment and a separate subsection exists concerning the definition of "employment." No such definition of "employment" exists for income tax withholding purposes. Further, the FICA and FUTA included-excluded rule relates to "employment" whereas the income tax withholding rule relates to "wages." Despite these distinctions, there is authority for interpreting the income tax withholding rule in the same manner as the FICA and FUTA for this purpose.

The income tax withholding provisions had their origin in the Revenue Act of 1942, 56 Stat. 884. Many of the income tax withholding exceptions were designed to be similar to the FICA and FUTA tax exceptions. Senate Rep. No. 1631, 77th Cong., 2d Sess., 166 (1942), stated as follows with respect to some exceptions from wages in the original income tax withholding provisions:

> These exceptions are identical with the exceptions extended to such services for Social Security tax purposes and are intended to receive the same construction and have the same scope.

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5 The "contemporaneous construction" referred to by the court was contained in S.S.T. 402, 1940-2 C.B. 252. The ruling stated as follows, at 1940-2 C.B. 253:

> In the opinion of the Bureau, section 1426(c) and section 1607(d), supra, were not intended to include as "employment" services performed outside the United States or to exclude from "employment" services performed within the United States on the basis of the relations in quantity of services performed within the United States to the entire services performed both within and without the United States.

The references to section 1426(c) and section 1607(d) are to the predecessors of section 3121(c) and section 3306(d). (Section 3306(d) contains the Federal Unemployment Tax Act (FUTA) included-excluded rule.)

The 1942 Act also provided an additional exception from the definition of wages for "services performed as an employee while outside the United States..., unless the major part of the services performed during the calendar year by such employee for such employer are performed within the United States." See section 465(b)(7) of 1942 Act. The committee reports state that "the exception does not extend to wages paid an employee whose services are performed partly within and partly without the United States if the major portion of such employee's services during the year are performed within the United States." Sen. Rep. No. 1631 at page 167.

The 1942 Act also added the included-excluded rule for income tax withholding purposes with similar wording to the current section 3402(e). The legislative history states that:

> In order to avoid administrative difficulties, section 426(h) provides that if the remuneration paid for services performed during one-half or more of any payroll period constitutes wages, all the remuneration paid for such period shall be deemed to be wages; but if the remuneration paid for services performed during more than one-half of such payroll period does not constitute wages, then none of the remuneration paid for such period shall be deemed to be wages. The rule prescribed is similar to that adopted for social security tax purposes.

H.R. Rep. No. 2333, 77th Cong., 2d Sess., 127 (1942); Sen. Rep. No. 1631, 77th Cong., 2d Sess. 167 (1942).

A similar desire for ease of administration by having similar exceptions for purposes of the FICA, the FUTA, and federal income tax withholding was also evidenced in the legislative history of the Current Tax Payments Act of 1943, which enacted income tax withholding provisions that replaced the Revenue Act of 1942 provisions. See S. Rep. No. 221, 78th Cong., 1st Sess., 17 (1943); H.R. Rep. No. 510, 78th Cong., 1st Sess., 28 (1943). The 1943 Act changed the included-excluded rule by limiting its application to payroll periods of not more than 31 consecutive days. H.R. Rep. No. 510 at 38. The 1943 Act also excepts from the definition of wages remuneration paid for "services performed by a nonresident alien individual, other than a resident of a contiguous country who enters and leaves the United States at frequent intervals." See section 2(a) of 1943 Act.

In 1966, Congress changed the taxation of remuneration for services performed by nonresident aliens. See Public Law No. 89-809, 89th Cong., 2d Sess. (1963). Formerly, the performance of personal services by nonresident aliens within the United States had been subject to withholding only under section 1441. Section 3401(a)(6), as presently worded, was added to the Code by section 103(k) of Pub. L. 89-809 to provide for an exception from wages for such services as may be designated by regulations prescribed by the Secretary or his delegate. The legislative history describes the reason Congress made the 1966 change:

> Your committee believes that withholding at the 30-percent rate should only be required in the case of income that is taxed at that rate. Therefore, income that is effectively connected to the conduct of a U.S. trade or business should not be subject to this

> withholding tax at a 30-percent rate. This is particularly important in the case of compensation paid a nonresident alien.... Since the regular graduated rates on small incomes are less than 30 percent, this rate may result in substantial overwithholding in many cases where regular income tax rates apply. Although an alien may obtain a refund of the excess withholding when he files his return at the end of the year, overwithholding in these circumstances can create a substantial hardship for the alien.

H. R. Report No. 1450, 89th Cong., 2d Sess., 1, 24 (1966). See also Sen. Rep. No. 1707, 89th Cong., 2d Sess. 1, 30.

Consideration of *Inter-City Truck Lines*, *Ltd.,* Rev. Rul. 79-318, the legislative history of section 3402(e), the purposes of wage withholding, the income tax withholding regulations, and the over-withholding potentially produced by application of the rule in this context provide strong support for not applying section 3402(e) to nonresident alien crewmembers who perform a portion of their services within the United States. Thus, we conclude that section 3402(e) does not apply in this context.

Applicability of Section 1441:

If section 3402 withholding does not apply to U.S. source compensation paid to nonresident alien crewmembers, then section 1441 withholding would apply.

Section 1441 provides, in pertinent part, that any person paying "wages, ... compensations, remunerations, ... or other fixed or determinable annual or periodical gains, profits, and income" constituting U.S. source gross income must deduct or withhold 30% thereof. As already noted, the nonresident alien crewmember's performance of services within the United States will generally constitute engaging in a U.S. trade or business. Therefore, any part of their compensation that is U.S. source will be taxed as income effectively connected with a U.S. trade or business.[6] While section 1441(c)(1) provides an exception from withholding under section 1441 for certain income that is effectively connected with a U.S. trade or business, this exception does not apply to compensation for personal services performed by an individual.[7] Under section 1441(c)(4), regulations may exempt

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6 See I.R.C. §§ 864(b) and (c)(2); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the United States, which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

Note that the exception for $3,000 or less earned during 90 days or less in the United States will not apply, since the foreign transportation entity will itself necessarily be engaged in a U.S. trade or business by virtue of performing services in the United States or U.S. territorial waters during trips between U.S. and foreign destinations. See I.R.C. §§ 861(a)(3)(C)(i), 864(b)(1)(A); Treas. Reg. §§ 1.861-4(a)(1)(iii)(a), 1.864-2(b)(1)(i).

7 Accord, Treas. Reg. § 1.1441-4(a)(1).

compensation for personal services from withholding under section 1441.

In pertinent part the regulations pursuant to section 1441(c)(4) provide for only two exemptions. Under Treas. Reg. § 1.1441-4(b)(1)(i), withholding under section 1441 is not required if the personal services compensation of the nonresident individual is subject to withholding under section 3402. Therefore, as long as the employer is withholding on the nonresident alien's compensation under section 3402, withholding under section 1441 is not required.

The second exception for withholding under section 1441 is contained in section 1.1441-4(b)(1)(ii). Withholding under section 1441 is not required if the personal services compensation of the nonresident alien individual would be subject to withholding under section 3402 but for the provisions of section 3401(a), other than section 3401(a)(6). However, as discussed above, any inapplicability of section 3402 withholding to the compensation of nonresident alien crew is not the result of one of the exceptions under section 3401(a).

Accordingly, if employers argue withholding under section 3402 does not apply, the U.S. source compensation of nonresident alien crewmembers would then be subject to withholding under section 1441.

Exceptions to Applicability of Section 1441:

Withholding is not required under section 1441 either for compensation for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the United States at frequent intervals, or for compensation which is, or will be, exempt from income tax by reason of a tax treaty to which the United States is a party.[8] The regulations set forth the Form 8233 procedure for obtaining the treaty exemption.[9]

Withholding is also not required if compensation is exempt from withholding under section 3402 by reason of section 3402(e) and the employee and employer enter into an agreement under section 3402(p) to provide for the withholding of income tax. Treas. Reg. § 1.1441-4(b)(1)(vi). However, as discussed above, section 3402(e) does not apply to nonresident alien crewmembers.

Source of Personal Services Income:

Section 3402 and section 1441 only apply to items of income from U.S. sources. Section 863(c) generally sources income from transportation activities. However, wages paid in connection with

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8 Treas. Reg. § 1.1441-4(b)(1)(iii)&(iv). The latter provision also would exempt from withholding under section 1441 compensation exempt from income tax under a provision of the Internal Revenue Code. Note, the exemption under section 872(b) for income from the international operation of ships and aircraft would not be available, since crew members are not the operators.

9 Treas. Reg. § 1.1441-4(b)(2).

international transportation between U.S. and foreign destinations are not sourced under section 863(c). Rather, they are sourced under sections 861(a)(3) and 862(a)(3). Under these sections, compensation for services performed in the United States is treated as U.S. source, and compensation for services performed outside the United States is treated as foreign source.

Since the compensation paid to nonresident alien crew members for services during trips between U.S. and foreign destinations is partly for services within the United States and partly for services outside the United States, an allocation and apportionment must be made to determine the amount paid for services within the United States to which withholding under section 1441 applies. As noted, services within U.S. territorial waters are considered within the United States for these purposes.[10] The regulations provide for the division to be made on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.[11] In many cases, the facts and circumstances will be such that an apportionment on the time basis will be acceptable. For example, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.[12] In some cases in which taxpayer's services are performed and an accurate record of all of the hours of service is available, an allocation of compensation for labor or personal services performed by the taxpayer between U.S. and foreign sources shall be made by comparing the hours of service performed in the United States and the total hours of service.[13]

Inapplicability of FICA and FUTA:

Services performed within the United States by a nonresident alien crew member on or in connection with a foreign flag vessel or aircraft are excepted from the definition of employment for purposes of the FICA and the FUTA if the employee is employed by such employer on and in connection with such vessel or aircraft when outside the United States.[14]

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10 See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

11 Treas. Reg. § 1.861-4(b)(1)(i).

12 Id. See also Treas. Reg. § 1.863-4(c)("For example, ship wages ... shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage ....").

13 Rev. Rul. 77-167, 1977-1 C.B. 239 (allocation of airline pilot's compensation by comparing hours of flight and required preflight services performed in the UNITED STATES to the total hours of such services).

14 I.R.C. §§ 3121(b)(4), 3306(c)(4).

Rules for Resident Aliens Not Addressed:

This discussion is limited to nonresident alien crew members. Different rules apply for U.S. resident aliens or U.S. citizens. Section 7701(b) and the regulations thereunder define when resident alien status is acquired. Generally, there are two tests, one based on permanent immigrant status (green card test) and the other based on presence in the United States for a sufficient period of time measured by an objective formula (substantial presence test). In reviewing a time allocation of a purported nonresident alien's service between U.S. and foreign sources, the possibility should be kept in mind that time in the United States above a threshold could affect classification of the crew member as nonresident or resident alien.

CONCLUSION:

In cases involving international transportation other than transportation to a U.S. possession, case law and the legislative history of the withholding statute indicate U.S. source compensation paid by a foreign corporation to nonresident alien crew for services is generally subject to withholding under section 3402.

However, employers that fail to withhold under section 3402 must as an alternative withhold under section 1441 for U.S. source wages paid to nonresident alien crew employees in connection with international transportation (other than to U.S. possessions). If they withhold under section 1441, they must file Forms 1042 and 1042-S with respect to such payments. No refunds shall be granted unless the refund claim on Form 1040NR bears a taxpayer identification number that matches the number stated on the corresponding Form 1042-S.