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SETTLEMENT GUIDELINE

Federal Income Tax Withholding on Compensation Paid to Nonresident Alien Crew by a Foreign Transportation Entity

Effective Date: JUN - 2 1998

ISSUE

Whether compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the U.S. on trips between U.S. and foreign destinations should be subject to withholding tax under IRC §3402 or IRC §1441? (For the Shipping Industry, the settlement guideline for this coordinated issue applies to compensation paid for services performed in taxable years beginning on or before December 31, 1997.)

EXAMINATION DIVISION'S POSITION

For wages paid to nonresident alien crew in cases involving international transportation, other than transportation to a U.S. possession, the regulations under IRC §1441 are technically applicable. However, case law also supports withholding under IRC §3402 in lieu thereof. Although employers may follow either method, Examination Division recommends the use of the IRC §3402 provisions in order to avoid unnecessary refund claim procedures and minimize taxpayer burden.

DISCUSSION

The issue typically involves foreign corporations engaged in a trade or business in the United States through the operation of ships or aircraft that employ nonresident alien crew to perform services on the vessel or aircraft. Specifically, the issue addresses the withholding requirements of the foreign transportation entities on compensation paid to nonresident alien crew for services performed within the United States. The coordinated issue paper limits its discussion to transportation between U.S. and foreign destinations; it does not consider transportation that begins and ends in the U.S. on "cruises to nowhere" or transportation to or from a U.S. possession.

The position taken by Examination Division in the coordinated issue paper is interesting in that it advises to take a practical approach in addressing this issue, even though such approach may not be technically sustainable. IRC §3402(e) would possibly eliminate the compensation at issue from the withholding requirements of IRC §3402; however, the withholding provisions of IRC §1441 would apply. Nonetheless, if

an employer is withholding on the U.S. source portion of the compensation using the provisions of IRC §3402, acceptance of that method is advised in the interest of sound tax administration. As discussed below, this approach is reasonable and pragmatic.

Applicability of IRC §3402

Although the compensation paid to crew members for services performed would generally be considered "wages" under IRC §3401(a), an exception is provided "for such services, performed by a nonresident alien individual, as may be designated by regulations prescribed by the Secretary," under IRC §3401(a)(6).

Treasury Reg. §31.3401(a)(6)-1(a) provides that unless otherwise excepted under that section, all remuneration paid for services performed by a nonresident alien individual is subject to withholding under IRC §3402, if such remuneration otherwise constitutes wages, and if such remuneration is effectively connected with the conduct of a trade or business within the United States. Remuneration paid to nonresident alien individuals for services performed outside the United States is excepted from wages and is excluded from withholding requirements under Reg. §31.3401(a)(6)-1(b).

Under the above provisions, it must be determined if the remuneration is effectively connected with the conduct of a trade or business within the United States. Under IRC §864(b) and Reg. §1.864-2(a), the term "engaged in trade or business within the United States" includes the performance of personal services within the United States at any time within the taxable year. Under Reg. §1.864-4(c)(6)(ii), compensation received by a nonresident alien individual for performing personal services in the United States which, under Reg. §1.864-2(a) constitutes engaging in a trade or business in the United States, also constitutes income which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that individual.

Two areas of concern should be noted in regard to Reg. §1.864-2(a):

(1) The discussion in the regulation of the term "engaged in trade or business within the United States" pertains to its use in part I (section 861 and following) and Part II (section 871 and following), subchapter N, chapter 1 of the Code, and chapter 3 (section 1441 and following) of the Code. IRC §3402 is contained in chapter 24, subchapter A of the Code, thus the applicability of the IRC §864 regulations to IRC §3402 comes into question. Although IRC §3402 is not specifically addressed in the regulation, it appears reasonable to conclude that the definition provided under IRC §864(b) and the regulations thereunder could be applied to the withholding requirement of IRC §3402.

(2) IRC §864(b) provides an exception for personal services performed for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, by a nonresident alien individual present in the U.S. for a period or periods not exceeding 90 days during the taxable year and whose compensation for such services does not exceed $3,000 in the aggregate. This exception could substantially reduce or eliminate the required withholding in some cases, since the crew would frequently not exceed the time and dollar limitations cited in the code section.

The coordinated issue paper notes that this exception will not apply, since the foreign transportation entity would itself be engaged in a U.S. trade or business by virtue of performing services in the U.S. or U.S. territorial waters during trips between the U.S. and foreign destinations (the issue paper cites IRC §§861(a)(3)(C)(I) & 864(b)(1)(A), and Reg. §§1.861-4(a)(1)(iii)(a) & 1.864-2(b)(1)(I)). However, a reading of these sections does not lead one to the conclusion that every foreign transportation entity would necessarily be engaged in a U.S. trade or business due to the performance of some service in U.S. territorial waters. Reg. §§1.861-4(a)(3) & 1.864-2(b)(2)(ii) both state:

> Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

An issue could arise as to whether the foreign transportation entity was engaged in a trade or business within the United States, and a facts and circumstances review of the particular case would be required, as stated in Reg. §1.864-2(e). Case law indicates that a foreign person will be engaged in a U.S. trade or business if its U.S. activities are "considerable, continuous, and regular." Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), aff'd per curiam, 55-1 USTC ¶9339 (9th Cir. 1955). See also Inverworld, Inc. et al., v. Commissioner, 71 TCM 3231 (1996). Generally speaking, it seems likely that a foreign transportation entity whose vessels frequently call at U.S. ports during the year would satisfy this standard; however, factual development of the nature and extent of the entity's economic activities may be required if the issue arises.

With the exception of the possible issues noted above, the aforementioned provisions lead to the conclusion that the compensation paid to nonresident alien crew would be subject to withholding under IRC §3402 to the extent that services were performed within the United States. However, a further exception is provided by IRC §3402(e), which states in part that "if the remuneration paid by an employer to an employee for

services performed during more than one-half of any such payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed to be wages."

Reg. §31.3401(a)(6)-1(b) specifically excepts payments made to nonresident alien crew for services performed outside the U.S. from the definition of "wages." Since more than half of the compensation for a pay period for nonresident alien crew employed on trips between U.S. and foreign ports will typically be attributable to the performance of services outside the U.S., it would seem that none of the compensation paid to the nonresident alien crew would be subject to IRC §3402 withholding due to the IRC §3402(e) exception. However, proposed regulations have attempted to address this problem for employees and employers who would prefer to withhold under IRC §3402 rather than IRC §1441. Compensation which would normally be exempt from withholding under IRC §3402 by reason of IRC §3402(e), will be exempt from withholding under IRC §1441 under Proposed Reg. §1.1441-4(b)(1)(vi), if the employee and his employer enter into a voluntary withholding agreement under IRC §3402(p). Thus, the proposed regulation specifically provides for withholding under IRC §3402 rather than IRC §1441, even though the compensation would normally be exempt under IRC §3402(e). This provision reaches the same result as recommended in the Examination position paper, thereby accomplishing the goals of avoiding unnecessary refund claims and minimizing taxpayer burden.

In addition to the proposed regulation, case law also brings the application of IRC §3402(e) into question. Although the language of IRC §3402(e) seems clear, related language regarding FICA taxes was brought to issue in Inter-City Truck Lines, Ltd. v. U.S., 408 F.2d 686 (Ct. Cl., 1969). This case involved Canadian truck drivers who spent less than one-half of any payroll period performing duties which constituted "employment." IRC §3121(b) provides generally that the term "employment" includes (A) any service performed by an employee for an employer, irrespective of the citizenship or residence of either, within the U.S. or (B) outside the U.S. by a citizen of the U.S. as an employee for an American employer. IRC §3121(b) then lists 21 exceptions to the definition of employment. However, there is also a FICA tax exception similar to the withholding exception found in IRC §3402(e). Under IRC §3121(c), if the services performed during more than one-half of any payroll period do not constitute employment, then none of the services for such period shall be deemed employment.

The petitioner reasoned that since it employed Canadian truck drivers who spent less than one-half of their time performing duties within the U.S., the drivers would not be subject to FICA taxes under the "all or nothing" provisions of IRC §3121(c).

The Court of Claims disagreed. It reasoned that the all or nothing rule under IRC §3121(c) applies only to services performed by employees which engage in some services which are included under IRC §3121(b), and some services which are excluded under the specific exceptions of IRC §3121(b). To support the opinion, the Court referred to the legislative history of IRC §3121(c), and to a 1940 ruling wherein the provisions of §1426(c) of the Internal Revenue Code of 1939 (the predecessor of IRC §3121(c) of the 1954 Code), were determined to not apply to flight personnel of an airline operating between foreign and United States airports. S.S.T. 402, 1940-2 CB 252. The ruling stated, in part:

> In the opinion of the Bureau, sections 1426(c) and 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 relation in quantity of services performed within the United States to the entire services performed both within and without the United States. Accordingly, it is held that such sections are not applicable with respect to the services performed by the flight personnel of the M Air Lines.

The determination by the Court of Claims was embraced in Rev. Rul. 79-318, 1979-2 C.B. 352, which described the same fact pattern presented to the Court.

Although the Court of Claims supported the notion that a nonresident alien employee would not be exempt from FICA tax under IRC §3121(c) irrespective of what percentage of the employee's total services was performed within the U.S., this finding, by itself, does not irrefutably support the imposition of withholding taxes under IRC §3402 for nonresident alien crew, for the following reasons:

- the issue in Inter-City Truck Lines, supra, involved the definition of "employment" for FICA tax purposes, not "wages" for withholding tax purposes.

- the Court of Claims refused to accept a literal reading of IRC §§3121(b) & (c), which would indicate that the services performed by the Canadian truck drivers were outside the definition of the term "employment" for FICA purposes, taking instead a narrow interpretation of the law by determining that IRC §3121(c) can only be considered in conjunction with the specific exceptions of IRC §3121(b).

- services performed by nonresident alien crew on a non-American vessel or non-American aircraft are generally excepted from the term "employment" under one of the specific exceptions (IRC §3121(b)(4)). Thus, the issue of FICA withholding for nonresident alien crew would likely have been decided differently by the Court of Claims.

There is no specific exclusion for nonresident alien crew in the income tax withholding provisions of IRC §3401, thus we are again faced with whether nonresident alien crew would come under the "all or nothing" rule of IRC §3402(e). Although a court might reach the same result for income tax withholding as was determined for FICA taxes in Inter-City Truck Lines, supra, there is a degree of uncertainty on this issue.

Despite the provisions of IRC §3402(e), the proposed regulations and case law noted above provide an arguable basis for imposing withholding tax under IRC §3402, and certainly provide an acceptable administrative alternative to IRC §1441, even if the withholding provisions of IRC §1441 would be determined to be technically applicable.

Applicability of IRC §1441

IRC §1441 provides for withholding at a 30% rate by any person paying "salaries, wages, · · · compensations, remunerations,· · · or other fixed or determinable annual or periodical gains, profits, and income" constituting gross income from sources within the United States. As previously discussed, services performed within the U.S. constitute engaging in a U.S. trade or business, and U.S. source income will be taxed as income effectively connected to the U.S. trade or business. Although IRC §1441(c)(1) provides an exception for withholding on effectively connected income, the Code specifically states that the exception does not apply to compensation for personal services. Reg. §1.1441-4(b)(1) provides exemptions from withholding on compensation for personal services of a nonresident alien individual if the compensation is effectively connected with the conduct of a trade or business within the U.S. and:

(i) Such compensation is subject to withholding under IRC §3402. Even if withholding under IRC §3402 is applicable for the reasons discussed above, compliance would still be achieved since the employer would be withholding under the provisions of IRC §3402.

(ii) Such compensation would be subject to withholding under IRC §3402 but for the provisions of IRC §3401(a) (other than paragraph (6) thereof) and the regulations thereunder. As previously discussed, if the withholding requirements of IRC §3402 do not apply, it is due to the exception under IRC §3402(e), rather than any of the exceptions listed in IRC §3401(a).

When does IRC §1441 not apply?

First, the exception for nonresident aliens working for a foreign employer not engaged in a U.S. trade or business, if the employee meets the less than 90 day and $3,000 rule, would apply to withholding under IRC §1441 as well. As discussed above, the foreign employer would likely be engaged in a U.S. trade or business. The applicable

facts and circumstances would have to be considered, however, if the issue presented itself in a particular case.

Also, under Reg. §§1.1441-4(b)(1)(iii) & (iv), compensation for personal services of a nonresident alien individual is not subject to withholding if the compensation is effectively connected with the conduct of a trade or business within the U.S., and such compensation is 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 the income tax imposed by Chapter 1 of the Code by reason of a provision of the Internal Revenue Code or a tax treaty to which the U.S. is a party.

Which provisions should be used - IRC §3402 or IRC §1441?

If IRC §3402 does not apply to the U.S. source compensation for nonresident alien crew, then withholding would apply under the provisions of IRC §1441, except as noted above. If withholding under IRC §1441 is imposed, the amount withheld would be 30% of the gross compensation.

By withholding under the provisions of IRC §1441, an excessive amount of tax will normally be withheld, since the nonresident alien's U.S. source income would actually be taxed under IRC §871(b) using taxable rather than gross income, and using the same graduated rates that apply to U.S. taxpayers (which start at 15%) rather than a flat rate of 30%. Although claims for refund could be filed by the nonresident alien crew members for the excess withholding, the administrative process is unwieldy and causes additional resources to be expended by both the taxpayers and the Service.

The more efficient method is for the foreign transportation entity to follow the provisions of IRC §3402; the tax would then effectively be withheld using the proper tax base and rate, and the need to subsequently file claims for refund would be eliminated. Although greater withholding is technically allowable under IRC §1441, the proper tax would be withheld under IRC §3402 and administrative burdens to the taxpayer and the Government would be eliminated. If the employer is properly withholding under IRC §3402, the coordinated issue paper recommends that enforcement of the withholding provisions of IRC §1441 in lieu of IRC §3402 would not be appropriate. Under the circumstances, this approach is sensible and should be followed.

It should be noted that the foreign transportation entity may wish to follow the IRC §1441 withholding requirements if all or a substantial portion of their crew are nonresident aliens exempt or partially exempt from withholding by treaty. In that instance, the requirements for obtaining such exemptions are spelled out in Reg. §1.1441-4(b)(2).

Sourcing the personal service income

Since the services performed by the crew on voyages between U.S. and foreign destinations occur partly within the U.S. and partly outside the U.S., an allocation must be made to determine the amount of compensation subject to withholding, since only the U.S. sourced compensation earned by the nonresident alien crew members is subject to withholding. The determination of the appropriate allocation is likely to be an area in which disagreements arise.

Under Reg. §1.861-4(c), wages received for services rendered inside the territorial limits of the United States are considered U.S. source wages. Reg. §1.861-4(b)(I) states that the allocation between U.S. and foreign source income should be made "on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case." The regulation also states:

> In many cases the facts and circumstances will be such that an apportionment on the time basis will be acceptable, that is, 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. In other cases, the facts and circumstances will be such that another method of apportionment will be acceptable.

Although the regulation describes an allocation based upon the number of days service is performed within the U.S. compared to the total number of days for which service is performed, arguments for acceptable alternative methods could certainly be expected from taxpayers. The regulation indicates that the facts and circumstances of each case would have to be evaluated, with an eye toward using a time allocation whenever appropriate. Rev. Rul. 77-167, 1977-1 C.B. 239 (airline pilot), and Rev. Rul. 76-66, 1976-1 C.B. 189 (hockey player), provide further discussions regarding the allocation of income between U.S. and foreign sources. (In reading the revenue rulings, be aware that the provision in Reg. §1.861-4(b)(I) allowing another appropriate method of allocation depending upon the facts and circumstances of the case applies to years beginning after December 31, 1975). Also, Favell v. U.S., 89-1 USTC ¶9287 (Ct. Cl. 1989), and Stemkowski v. Commissioner, 82-2 USTC ¶9589 (2nd Circ. 1982), discuss sourcing of income for hockey players.

Application of FICA and FUTA

Nonresident alien crew serving on a foreign-flag vessel or aircraft will normally be excepted from FICA and FUTA. See IRC §3121(b)(4) and IRC §3306(c)(4) for the applicable FICA and FUTA provisions.

Section 530, IRC §3509, and Back-up Withholding

Section 530 of the Revenue Act of 1978 was passed as a relief provision for employers who improperly treat workers as independent contractors instead of employees, but had a reasonable basis for their position. However, relief is only provided if the employer is consistent in the treatment of the workers, and timely filed all necessary forms, such as Forms 1099. Typically, the foreign transportation entity (employer) will not have filed Forms 1099 for the nonresident alien crew, and will therefore not be entitled to relief under Section 530.

IRC §3509 also provides relief, in the form of lower withholding rates, to employers who have workers reclassified from independent contractors to employees by the Service. Relief can be obtained even if Forms 1099 are not filed for the workers. However, if the failure to withhold is due to intentional disregard of the withholding requirements, IRC §3509 will not apply.

For relief to apply under either provision, the issue must relate to misclassification of employees as independent contractors, which would be unlikely in the typical case. Therefore, care must be taken to ensure that the relief provisions are only considered under the appropriate circumstances.

If a taxpayer establishes that nonresident alien crew are independent contractors, but did not comply with the information reporting and backup withholding provisions, it could be subject to assessment of the backup withholding and applicable penalties. Although it does not appear that the "independent contractor" argument would be successful in most instances, the backup withholding and penalty provisions should be reviewed when applicable.

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