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

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MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) (by Jerry E. Holmes)

SUBJECT: Income Tax Withholding on Compensation Paid to Nonresident Alien

By this memorandum, we withdraw our chief counsel advice of February 5, 1999. At your request, we are reconsidering the issue raised in that chief counsel advice.

If you have any questions, call the branch telephone number.

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MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) (by Jerry E. Holmes)

SUBJECT: Income Tax Withholding on Compensation Paid to Nonresident Alien

This memorandum is in reply to your request that we reconsider the conclusion that the "included-excluded" rule of section 3402(e) of the Code does not apply to remuneration paid to nonresident aliens who perform a portion of their services within the United States and the remainder of their services outside the United States.

Under the included-excluded rule of section 3402(e), if remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, then all the remuneration paid by such employer to such employee for such period shall be deemed to be wages. Conversely, 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.

For purposes of this memorandum, we assume that the compensation of the nonresident aliens is not exempt from United States federal income tax or employment tax withholding under an income tax convention or a social security totalization agreement. A common situation is that only a small portion (usually less than 50 percent) of the total remuneration of the nonresident alien is United States source income. Thus, If nonresident aliens perform less than half of their services in the United States, the practical effect of applying section 3402(e) is that withholding on the nonresident aliens would be under section 1441 rather than

section 3402.[1] As a result, withholding would generally apply to remuneration for services performed within the United States.

ISSUE

Whether section 3402(e) applies when a nonresident alien employee performs a portion of his or her services as an employee within the United States and the remainder of the services outside the United States.

CONCLUSION

Section 3402(e) does not apply.

DISCUSSION

Section 3402(a) requires every employer making payment of wages to deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary.

Section 3401(a) defines "wages" as all remuneration for employment, with certain specific exceptions. Section 3401(a)(6) provides an exception from the definition of wages for such services, performed by a nonresident alien individual as may be designated by regulations prescribed by the Secretary.

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[1] Under the new section 1441 regulations, a specific provision has been added relating to section 3402(e). See Section 1.1441-4(b)(1), as amended by T.D. 8734, effective January 1, 2000. Section 1.1441-4(b)(1) provides that section 1441 withholding is not required under section 1.1441-1 from salaries, wages, remuneration, or any other compensation for personal services of a nonresident alien individual if such compensation is effectively connected with the conduct of a trade or business within the United States and –

(i) Such compensation is subject to withholding under section 3402 and the regulations under that section;

(ii) Such compensation would be subject to withholding under section 3402 but for the provisions of section 3401(a) (not including paragraph (6) of that section) and the regulations under that section...

(vi) Compensation that is exempt from withholding under section 3402 by reason of section 3402(e), provided that the employee and his employer enter into an agreement under section 3402(p) to provide for the withholding of income tax upon payments of amounts described in section 31.3401(a)-3(b)(1) of the regulations [i.e., remuneration for services that is not wages].

Section 31.3401(a)-2(a)(1) of the Employment Tax Regulations provides that the term "wages" does not include any remuneration for services performed by an employee for his or her employer which is specifically excepted from wages under section 3401(a). Section 31.3401(a)-2(a)(2) provides that the exception attaches to the remuneration for services performed by an employee and not to the employee as an individual; that is, the exception applies only to the remuneration in an excepted category.

Section 31.3401(a)(6)-1(a) of the regulations provides that all remuneration paid after December 31, 1966, for services performed by a nonresident alien individual, if such remuneration otherwise constitutes wages within the meaning of § 31.3401(a)-1 and if such remuneration is effectively connected with the conduct of a trade or business within the United States, is subject to withholding under section 3402 unless excepted from wages under this section.

Section 31.3401(a)(6)-1(b) of the regulations provides that remuneration paid to a nonresident alien individual (other than a resident of Puerto Rico) for services performed outside the United States is excepted from wages and hence is not subject to withholding.

Section 31.3401(a)(6)-1(e) provides that remuneration paid for services performed within the United States by a nonresident alien individual is excepted from wages and hence is not subject to withholding if such remuneration 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 an income tax convention to which the United States is a party.

Section 3402(e) provides that if the remuneration paid by an employer to an employee for service performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by such employer to such employee for such period shall be deemed to be wages, but 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. This provision is known as the "included-excluded rule."

Section 31.3402(e)-1(a) of the regulations provides that for purposes of the included-excluded rule, the relative amounts of time spent performing services that generate section 3401(a) wages and non-section 3401(a) remuneration determine whether all the remuneration for services performed during the payroll period is treated as “included” or “excluded.”

Section 31.3402(e)-1(b) of the regulations provides that if one half or more of the employee's time in the employ of a particular employer in a payroll period is spent performing services the remuneration for which constitutes wages, then all the remuneration paid the employee for services performed in that payroll period shall be deemed to be wages.

Section 31.3402(e)-1(c) of the regulations provides that if less than one half of the employee's time in the employ of a particular employer in a payroll period is spent performing services the remuneration for which constitutes wages, then none of the remuneration paid the employee for services performed in that payroll period shall be deemed to be wages. The regulation contains two examples, neither of which involves amounts excepted from wages under section 3401(a)(6).

Example 1 of section 31.3402(e)-1(d) of the regulations concerns an employer who operates a store and a farm and hires an employee to perform services in connection with both enterprises. The regulations state that the remuneration paid for services on the farm is excepted as remuneration for agricultural labor,[2] and the remuneration for services performed in the store constitutes wages. The employee is paid on a monthly basis. During each month the employee performs some services for the farm and some for the store. The example illustrates that, because of the included-excluded rule, the determination of whether the total remuneration is subject to income tax withholding depends upon whether the employee's hours of service for the store during the payroll period are equal to or greater than the hours of service for the farm during the payroll period.

Example 2 of section 31.3402(e)-1(d) contains another fact situation illustrating the included-excluded rule. Under this example, the employee performs services in the same payroll period for the same employing individual in the office and domestic service in the employer's private home. The remuneration for services in the home is excepted from the definition of wages by section 3401(a)(3) and the remuneration for services in the office constitutes wages. The example again provides that the application of the included-excluded rule depends on the relative hours of service performed in each type of employment in the payroll period.

Thus, under the two examples, remuneration for services that are excepted from wages under section 3401(a)(2) or section 3401(a)(3) is deemed to be subject to the included-excluded rule when such services are performed in the same payroll period as other services which result in remuneration that comes within the

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[2] Under section 3401(a)(2) at the time the regulation was promulgated, remuneration for agricultural labor was excepted from wages. Under current section 3401(a)(2), remuneration for agricultural labor is excepted unless the remuneration for such labor is FICA wages as defined in section 3121(a).

definition of wages. Based on these two examples, an argument could be made that remuneration for services excepted by section 3401(a)(6) would also be subject to the included-excluded rule when combined in the same payroll period with remuneration for services that is wages. Thus, if less than half an employee's time were spent on services within the United States in a payroll period, no withholding would apply under section 3402. As a result, withholding under section 1441 would apply.

However, it is necessary to consider relevant authority under the FICA dealing with the included-excluded rule. The authority under this parallel provision indicates that the included-excluded rule does not apply to section 3401(a)(6) type wages. The FICA has an included-excluded rule in section 3121(c) that is similar to the rule for income tax withholding purposes. Section 3121(c) provides that if the services performed during one half or more of any pay period by an employee constitute employment, all of the services performed during such period shall be deemed to be employment; but if the services performed during more than one half of a pay period by an employee do not constitute employment, then none of the services shall be deemed to be employment. The authority under this parallel provision indicates that the included-excluded rule does not apply to section 3401(a)(6) type wages.

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 performance of services in Canada by these workers was not excepted by one of the enumerated exceptions from employment beginning with section 3121(b)(1). However, those services did not fall within the basic definition of "employment" contained in the flush language at the beginning of subsection (b) of section 3121 because they were services performed outside the United States by a foreign citizen for a foreign employer.

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 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. Under this approach, if less than half a nonresident alien employee's time were spent on services within the United States, these amounts would be subject to withholding under section 3402.

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), which reached the same conclusion as the ruling. The court in that case rejected a literal reading of section 3121(c), which

seemingly supported the plaintiff's position. The court examined the legislative history and the "contemporaneous construction" of the provision by the Service.[3] 406 F.2d at 687-688. The court held that the included-excluded rule applies only where the employee is performing both (1) services that constitute employment and (2) services that fall within the basic definition contained in section 3121(b) and are excluded by one of the specific enumerated exceptions.

Although Rev. Rul. 79-318 and Inter-City Truck Lines provide direct authority for the interpretation of the 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, wages is defined as remuneration for employment and a separate subsection exists concerning the definition of "employment." Specifically, 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, we believe that 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. The legislative history of the 1942 Act demonstrates that Congress intended these exceptions to be interpreted similarly. Senate Rep. No. 1631, 77th Cong., 2d Sess., 166 (1942) stated as follows with respect to the exceptions from wages in the original income tax withholding provisions:

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[3] 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.)

> 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.

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).

This concern for simplicity and ease of administration was also evidenced in the legislative history related to the included-excluded rule. When the included-excluded rule was adopted for income tax withholding purposes, Congress specifically noted that "[t]he 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).

Consistency in interpretation between the FICA and the income tax withholding provisions supports the view that the included-excluded rule should not apply to the subject fact situation. Also, simplicity and ease of administration support reaching a conclusion on the income tax withholding included-excluded rule that is similar to the conclusion that has been adopted for purposes of the FICA rule.

We also believe that it would frustrate the intent of section 31.3401(a)(6)-1 of the regulations if the included-excluded rule were applied in this context. Section 3401(a)(6) provides an exception from wages only for such services performed by nonresident aliens as may be designated by regulations prescribed by the Secretary. Applying the included-excluded rule in the current context would unreasonably expand the exception from wages provided under section 3401(a)(6) for services performed by nonresident aliens beyond the scope of what was intended by the regulations.

In addition, it is doubtful that applying the included-excluded rule in the context of a situation where part of the remuneration is excluded from income and part is included in income is what was intended by the application of the rule. Generally, nonresident aliens are not subject to United States income tax on remuneration from services performed outside the United States. As a general rule, income tax withholding is intended to apply to amounts that are included in income and not amounts that are excluded from income. Thus, under section 31.3401(a)(6)-1(e) of the regulations, remuneration paid for services performed within the United States by a nonresident alien individual before January 1, 1999, is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from income tax imposed by chapter 1 of the Internal Revenue Code by reason of a

provision of the Internal Revenue Code or an income tax convention to which the United States is a party. (The nonresident alien employee is required to furnish a statement for this regulatory exception to apply.) Applying the included-excluded rule in a situation in which less than 50 percent of remuneration is excluded from income could result in withholding applying to 100 percent of a payment of remuneration for services even though just over 50 percent of the payment is included in gross income.[4] This discrepancy caused by the application of the rule in this context is entirely different from the ordinary application of the rule of administrative convenience under section 3402(e). In the examples under the section 3402(e) regulations, the amounts received by the employees (whether remuneration for services included in or excluded from wages) are in either event included in gross income.

The application of the included-excluded rule in this context would also be counter to the general concept that "wages is a narrower concept than income." Rowan Cos., Inc. v. United States, 452 U.S. 247, 254 (1981). At least three circuits, including one of national jurisdiction, apparently would conclude that to the extent the nonresident alien's remuneration is not includible in income, it cannot come within the basic definition of wages. Anderson v. United States, 929 F.2d 648 (Fed. Cir. 1991); Dotson v. United States, 87 F.3d 682 (5th Cir. 1996); and Gerbec v. United States, 1999 WL 12801 at page 9 (6th Cir., January 15, 1999) . Although the Service does not agree that amounts excluded from income are always also excluded from wages, these cases are appellate decisions and should not be ignored in considering this issue. If the holdings of these cases were applied, the payments to the nonresident aliens for services performed outside the United States would not be included in the basic definition of wages and there would be a direct analogy to Inter-City Truck Lines.

Consideration of the scope of the included-excluded rule must also acknowledge the practical effect of applying the rule to a nonresident alien performing only a portion of his or her services in the United States. As noted in Notice 92-6, 1992-1 C.B. 495, "[t]he principal purpose of wage withholding is to assure current payment of the correct amount of Federal income taxes." The federal income tax withholding regime under section 3402 is designed to have the withholding approximate the income tax liability of the recipient. Thus, in 1992, income tax withholding tables were revised because the previous tables were resulting in "substantial overwithholding" (i.e., the amounts withheld were substantially in excess of the income tax liabilities of the recipients). See Notice 92-6.

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[4] However, because the included-excluded rule is applied on a payroll period basis, an employee who performed just over the 50 percent in the United States in one payroll period, may be just under 50 percent in the next period.

It is generally agreed that applying the included-excluded rule of section 3402(e) in a situation in which a nonresident alien performs only a small portion of his services within the United States, together with section 1441, will produce much overwithholding. Withholding on nonresident aliens who perform less than 50 percent of their services in the United States will be at a 30 percent rate which will usually result in substantial overwithholding (unless a voluntary withholding agreement under section 3402(p) is in place).[5] Also in the case of nonresident aliens who perform a significant part of their services outside of the United States, but who perform 50 percent or more of their services within the United States, withholding under section 3402(a) on the entire amount of their remuneration will probably result in substantial overwithholding, because the remuneration for services outside the United States will generally be exempt from United States income tax. We do not believe that this substantial overwithholding was what Congress intended with the passage of the included-excluded rule. In contrast, our conclusion that the rule does not apply in this situation results in graduated withholding on the nonresident alien's remuneration for services within the United States that will correlate with the portion of his or her income tax liability that is computed under the graduated income tax tables under section 1.

The new section 1441 regulations have eliminated some of the force of the argument in the previous paragraph by providing that section 1441 withholding does not apply if a nonresident alien enters into a voluntary withholding agreement to have graduated withholding apply to his or her remuneration if his remuneration is excepted from wages as a result of section 3402(e). See section 1.1441-4(b)(1)(vi) of the regulations (set forth in footnote 1 of this memorandum). Thus, a nonresident alien could enter into a voluntary withholding agreement providing for withholding on his United States source income and satisfy the concerns of the previous paragraph. However, this rule would have no effect on the fact that if section 3402(e) were applied in a situation in which just over 50 percent of the nonresident alien's services were performed within the United States (and the remainder outside the United States), withholding would apply to amounts that generally were not subject to federal income tax (i.e., the remuneration for services performed outside the United States).

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[5] The lower stratum of an nonresident alien employee's income from services within the United States will generally be subject to a 15 percent rate and the next stratum at 28 percent, because remuneration for such service is effectively connected with the conduct of a trade or business within the United States. Section 871(b). In contrast, amounts that are subject to withholding under section 1441 are generally subject to an income tax rate of 30 percent which corresponds with the usual section 1441 withholding rate. Section 871(a).

The argument has been made that the statute is clear on its face, and section 3402(e) should apply under the literal language of the statute. However, the withholding statute cannot be applied without consideration of the legislative history and case law in the withholding area.

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

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

If you have any questions, call the branch telephone number.