

# ADVISORY

## SULLIVAN & WORCESTER TAX ADVISORY

### Final Regulations Issued on Source of Compensation for Services Performed Partly Within and Partly Without the United States

On July 13, 2005 the Treasury issued final regulations under Section 861 of the Internal Revenue Code concerning rules for determining the source of compensation for labor or services performed partly within and partly without the United States. The final regulations, which are effective for tax years beginning after July 13, 2005, adopt proposed regulations issued in 2004 with two minor changes. Specifically, the final regulations depart from the proposed regulations by broadening the definition of "education fringe benefits" and by indicating that relevant Federal tax forms will likely subject individuals with compensation over \$250,000 to stricter reporting requirements if they choose to use an alternative basis to determine the source of compensation.

Under the U.S. sourcing rules (primarily found in Code Sections 861-863 and 865), determinations are made as to whether a particular item of income is derived from U.S. sources or from foreign sources. For U.S. persons (that are taxable on their worldwide income), a foreign tax credit may be available (under Code Sections 901, 902 and 960) to reduce or eliminate the U.S. tax on foreign source income. Additionally, U.S. citizens and residents, who perform services abroad, may be able to exclude from U.S. taxation certain amounts of foreign source income derived from personal services (under Code Section 911). Finally, foreign persons are generally only subject to U.S. tax on their U.S. source income and on certain foreign source income that is "effectively connected" with a U.S. trade or business.

#### COMPENSATION PAID TO PERSONS OTHER THAN INDIVIDUALS AND TO INDIVIDUALS WHO ARE NOT EMPLOYEES

For persons who are not individuals and for individuals who are not employees, the regulations provide that the source of compensation is determined on the basis that most correctly reflects the proper source of the compensation under the facts and circumstances of the particular case, but in most cases the time basis will be appropriate.

**The Time Basis.** The amount of compensation for labor or personal services performed by any individual within the United States, as

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determined on the time basis, is calculated according to the ratio of the number of days of such performance within the United States to the total number of days of the performance of labor or personal services. Thus, if a taxpayer received compensation of \$150,000 for 100 hours of services performed within the United States and 50 hours performed without the United States, then the amount of compensation attributable to labor or personal services performed within the United States would be \$100,000.

The final regulations provide an example of where it is more appropriate to apportion compensation based on payroll costs than on the time basis. In the example, a corporation receives compensation for services performed within and without the United States by an equal number of employees working an equal number of hours, and the payroll cost related to the employees within the United States is twice that for the employees without the United States. The example concludes that the cost difference is due to the greater sophistication of services provided in the United States and thus it is appropriate to apportion the compensation according to the payroll costs. It is not clear if the payroll cost method similarly would be appropriate if the higher United States payroll costs merely reflected higher United States wage rates.

#### **COMPENSATION PAID TO INDIVIDUALS WHO ARE EMPLOYEES**

The regulations provide two bases for determining the proper source of compensation for individuals who are employees. As a general matter, the time basis is used to determine the source of all cash compensation and a geographical basis is used to determine the source of compensation from certain fringe benefits.

An employee may use an alternative basis if he can satisfy the Commissioner that the alternative basis more properly determines the source of the compensation than the applicable basis under the regulations. Additionally, the employee must retain documentation setting forth why the alternative basis more properly determines the source of the compensation and must provide the information related to the alternative basis required by applicable Federal tax forms. The Treasury has indicated that it expects these forms to have heightened requirements for individuals with

compensation of \$250,000 or more for the tax year. Such individuals will likely be required to attach to their income tax return a written statement that details information such as the specific compensation for which an alternative method is used, related computations and a comparison of the results of the alternative basis used and the applicable basis under the regulations.

Similarly, the Commissioner may determine that an alternative basis more properly determines the source of compensation than the applicable basis when the compensation is either not for a specific time period or constitutes a fringe benefit described in the regulations. Thus, the Commissioner apparently cannot challenge an employee's use of the time basis for non-fringe benefit compensation that relates to a specific period. Additionally, the regulations authorize the Commissioner to issue rulings and other pronouncements that would permit similarly situated employees who comply with both the pronouncement and the regulations to determine the source of their compensation under an alternative basis and be treated as having satisfied the Commissioner that such alternative basis is appropriate.

The Treasury has indicated that it will later issue special sourcing rules for artists and athletes.

#### **COMPENSATION FROM CERTAIN FRINGE BENEFITS DETERMINED ON A GEOGRAPHICAL BASIS.**

The source of compensation from the six fringe benefits defined in the regulations is determined on a geographical basis. To use the geographical basis, the fringe benefit must constitute reasonable compensation and the employee must substantiate each amount by adequate records or sufficient evidence. The geographical basis ordinarily corresponds to the employee's "principal place of work," as in the cases of housing, education, and local transportation. The employee's "principal place of work" is generally defined in Treasury Regulation Section 1.217-2(c)(3) as the place where the employee spends most of his or her working time (e.g., the premises of the employer). The geographic basis for determining the remaining three fringe benefits varies with each. For a tax reimbursement, the geographic basis is the location of the

jurisdiction that imposed the tax for which the individual is reimbursed. For hazardous or hardship duty pay the geographic basis is the location of the hazardous or hardship duty zone. The amount of compensation that may be treated as hazardous or hardship duty pay is limited to the amount that the United States government would allow its officers or employees present at that location. Finally, the geographic basis for determining the source of compensation for moving expense reimbursement is the location of the employee's new principal place of work, unless the employee provides sufficient evidence that the location of the employee's former principal place of work is more appropriate.

#### **COMPENSATION NOT FROM CERTAIN FRINGE BENEFITS DETERMINED ON THE TIME BASIS**

**Single-Year Compensation.** The source of compensation received by an employee for a single year is determined on the time basis unless the Commissioner concludes an alternate basis would more properly determine the source of the compensation. Although there is a presumption that the time period for which the compensation for labor or personal services is made is the calendar year in which the services are performed, if the Commissioner concludes that another time period, which must be separate, distinct and continuous, is more appropriate, then that time period should be used. For example, if an employee were transferred mid-calendar year to a foreign position lasting through the end of the calendar year, two separate time periods would generally be created with the transfer marking the end of the first time period and beginning of the second. The Treasury distinguishes this from a transfer to a foreign post that requires short-term returns to the United States to perform services, stating that such a pattern would not create a separate, distinct and continuous time period.

**Multi-Year Compensation.** The final regulations define multi-year compensation as "compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years." In this case, the time period would cover the

entire length of the project instead of the calendar year. In the case of stock options, the applicable time period to which compensation is attributable typically (but not necessarily in all cases) would be the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (i.e., the vesting of the option). Thus, the employee's location after the option vests usually would not be relevant, even if it was during that period that the option increased in value.

In sum, the final regulations substantially follow the proposed regulations. The source of compensation for persons who are not individuals and for individuals who are not employees is determined under the facts and circumstances of each case. The time basis will generally be used to determine the source of time-based employee compensation, including multi-year compensation such as stock options. The geographical basis, usually the employee's principal place of work, will generally be used to determine the source of compensation for all fringe benefits defined in the final regulations. However, different methods may be used if the taxpayer convinces the Commissioner that an alternative basis would more properly determine the source of the compensation or the Commissioner appropriately uses an alternative method for a non-time based situation.