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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR NEW YORK CITY APPEALS DIVISION AP:NY:JB

FROM: W. Edward Williams
Senior Technical Reviewer CC:INTL:BR 1

SUBJECT:

This Field Service Advice responds to your memorandum dated March 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:
Taxpayer =
Country A =
Country B =
Year C =
Year D =
Year E =
Year F =
Year G =
Year H =
Year I =
Year J =
Year K =
Year L =
U.S. Association =
Corporation X =
Corporation Y =
Services R =
Services S =
Article P =

ISSUES:

1. Whether Taxpayer was a resident of Country A during Year K for purposes of the United States-Country A Income Tax Convention so that the amounts distributed to him from a qualified pension plan maintained by Corporation Y are subject to tax only by Country A.

2. Whether any part of the compensation received by Taxpayer for services performed outside the United States during Years J and K is excludible from his gross income.

CONCLUSIONS:

1. On the basis of his Country A citizenship, Taxpayer was subject to a tax in Country A on his gross income in Year K. Therefore, he was entitled to benefits under the United States-Country A Income Tax Convention. The distribution that Taxpayer received from Corporation Y's qualified pension plan was subject to tax only by Country A pursuant to Article P.

2. The amount excludible from gross income is that portion which bears the same relation to the total compensation as the number of days of performance of services without the United States bears to the total number of days of performance of services during the taxable year.

FACTS:

ISSUE 1: Taxpayer was born in Year C in Country A. In Year D, he left Country A. In Year E, he became employed by the U.S. Association. In Year F, he lost his Country A citizenship, which he regained in Year G. Taxpayer returned to live in Country A in Year K after terminating his employment with Association.

Taxpayer is a joint owner with his wife and children of Corporation X, a foreign corporation, which owns real estate including condominium units in the United States. The condominium units are for Taxpayer's use when he is in the United States.

From Year E to mid-Year K, Taxpayer was employed by the U.S. Association. During Years J and K, all his earnings from the Association were paid either directly to Taxpayer or to Corporation Y, a U.S. corporation, of which Taxpayer is an employee and the sole shareholder. Corporation Y also received income from other activities of Taxpayer. He received an annual salary from Corporation Y for his services. Over the years, Corporation Y made contributions to a pension plan qualified under section 401(a) of the Internal Revenue Code. In Year K, substantial amounts were distributed to Taxpayer and his wife from this plan. Corporation Y was dissolved four years after Taxpayer's return to Country A.

On his Year J U.S. income tax return (Form 1040NR), Taxpayer indicated he was "stateless", but a permanent resident of Country B and that he traveled with a special Country B passport issued to him after he lost his Country A citizenship. On his Year K return, he reported that he was citizen of Country A, but a permanent resident of Country B and that he traveled with the Country B passport. Taxpayer is reported to have residences in Country A, B and a third country.

The pension distribution in Year K was disclosed on Taxpayer's U.S. income tax return (Form 1040NR) and excluded from gross income "per the US-Country B Treaty". Taxpayer claims that the pension income is excludible under Article P of the United States-Country A income tax convention. Although he claims the distributions are excludible from income tax, Taxpayer paid the 15-percent excise tax imposed on excess distributions by section 4980A(a) of the Code prior to its repeal by P.L. 105-34, § 1073(a), effective for distributions received after December 31, 1996. A Form 5329, Additional Taxes Attributable to Qualified Retirement Plans, was attached to his Year K Form 1040NR.

In Year L, Taxpayer and his wife entered into an agreement with Country A authorities to pay taxes at a certain percentage of their "gross annual income". There is on file a letter from the tax administration of Country A, confirming payment of taxes for Year K and the two following years to Country A in accordance with this agreement.

ISSUE 2: In Year H, Taxpayer entered into an employment contract with the U.S. Association (the "H Contract") for a term of two years from September of Year H to August of Year I. The H Contract states that Taxpayer was a resident of Country B on the date the contract was signed.

The H Contract required Taxpayer to perform personal services in the United States for approximately seven months each year. Taxpayer was also required to perform certain services the remainder of the year, although these services could be performed outside the United States. During the term of the H Contract, Taxpayer was barred from some but not all employment entailing services similar to those he performed for U.S. Association.

The H Contract provided for compensation to be paid weekly and for automatic increases should the consumer price index rise by more than 12 percent during a year. In addition, the U.S. Association agreed to purchase in each of the contract years an annuity contract which met the requirements of section 403(b) of the Internal Revenue Code. Taxpayer was also eligible under this contract to receive the benefits of all medical insurance, staff pension or other fringe benefits provided by the Association. While traveling for purposes devoted immediately and directly to the business of the Association, Taxpayer would be reimbursed for appropriate transportation, communication, hotel accommodation, meals, and the like.

For the period following the last of the two periods covered by the H Contract, instead of signing another contract individually, Corporation Y, as Taxpayer's employer, signed a contract with U.S. Association (the "J Contract") pursuant to which the corporation agreed to provide Taxpayer's services for a portion of Year J/Year K. The J Contract was substantially the same as the H Contract, except that Taxpayer's services were required in the United States only for a maximum of 10 weeks a year. If his services were requested for more than the original 10 weeks, the Association was obliged to pay a higher compensation. The Association also agreed to reimburse Corporation Y for all of Taxpayer's travels.

In addition to the H and J Contracts, Taxpayer and the U.S. Association entered into an agreement for Services R outside the United States in Year J at a set fee.

Finally, in Year J, Taxpayer and the U.S. Association entered into an agreement for Services S outside the United States in Year K. Under this agreement, which was similar to that signed for Services R, the Association agreed to pay Taxpayer a set fee and to reimburse him for all expenses.

On the Forms 1040NR that he filed for Years J and K, Taxpayer excluded all of the compensation he received for Services R and S. As to the compensation he received from Association for the regular employment period, he excluded the portion that represents the same proportion that the total days worked outside the United States is to the total days worked during the year both inside and outside the United States (197/239 for 1993; and 120/175 for 1994). The number of days worked outside of the United States (the numerator of the fraction) included the days spent on Services S and R for which Taxpayer was separately compensated as explained above.

LAW AND ANALYSIS

ISSUE 1.

This issue concerns only Year K. Taxpayer's claim is that he was a resident of Country A for purposes of the United States-Country A income tax convention and that the pension payments received from the qualified plan are, under Article P, subject to tax only by Country A. Sec. 894(a) provides that, to the extent required by a U.S. treaty, income will be exempt from U.S. income taxation[1]/.

Eligibility for benefits under a treaty is normally determined on the basis of residency. As stated in the Treasury Department Technical Explanation, Article P is drafted to ensure that source basis tax benefits granted by a Contracting State are limited to the intended beneficiaries, viz., residents of the other Contracting State. Article P of the United States-Country A Income Tax Treaty provides that pensions derived and beneficially owned by a resident of a Contracting State may be taxed only in that State.

The Article defining the term "resident" in the income tax treaty with Country A requires a person to be subject to tax in a State, by reason of domicile, residence or citizenship, to be a resident of that State for purposes of the treaty. While Taxpayer lost his Country A citizenship in Year F, his citizenship was restored in Year G, five years prior to the year in issue (Year K). While the extent to which Taxpayer's income was subject to Country A tax was unclear in Year K, the question was clarified in Year L by an agreement between Taxpayer and the tax administration of Country A. This agreement was retroactive to cover Year K, and Taxpayer paid tax pursuant to the agreement on the distributions from the pension plan maintained by Corporation Y. Under these circumstances, it is our view that Taxpayer was a resident of Country A for purposes of the United States-Country A Income Tax Convention for Year K.

The treaty with Country A does not contain a definition of the term "pension"; and therefore, the term is defined under the laws of the State applying the Convention (in this case, the United States). The Treasury Department's Technical Explanation for Article P states that the term "pension" includes both periodic and lump-sum payments by all private retirement plans and arrangements in consideration of past employment regardless of whether they are qualified plans under U.S. law.

Article 18(1) of the 1996 U.S. Model Income Tax Convention contains a pension provision similar to the one in Article P of the United States-Country A Income Tax Convention. The Treasury Department's Technical Explanation of the Model includes the following with respect to the definition of "pension":

> The phrase "pension distributions and other similar remuneration" is intended to encompass payments made by private retirement plans and

[1] All section references are to the Internal Revenue Code and all regulation section references are to Treasury Regulations as amended and applicable to the years at issue.

> arrangements in consideration of past employment. In the United States, the plans encompassed by Paragraph 1 include: qualified plans under section 401(a), plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts, non-discriminatory section 457 plans, section 403(a) qualified annuity plans, and section 403(b) plans. [Emphasis added.]

The Technical Explanation to the Model also states the following:

> In addition, certain distribution requirements must be met before distributions ... [will be treated as pension payments]. To qualify as a pension distribution or similar remuneration from a U.S. plan the employee must have been either employed by the same employer for five years or be at least 62 years old at the time of the distribution. In addition, the distribution must be made either (A) on account of death or disability, (B) as part of a series of substantially equal payments over the employee's life expectancy (or over the joint life expectancy of the employee and a beneficiary), or (C) after the employee attained the age of 55. Finally, the distribution must be made either after a separation from service or on or after attainment of age 65. A distribution from a pension plan solely due to termination of the pension plan is not a distribution falling under paragraph 1.

In this case, the distributions were made from a pension plan that qualified under section 401(a). Further, since taxpayer was born in Year C, he exceeded 65 years of age in Year K. Under these circumstances, it is our view that the distribution in Year K qualifies as a pension for purposes of Article P and that the distribution is subject to tax only in Country A.

ISSUE 2:

Pursuant to section 872(a), the gross income of a nonresident alien includes only (i) gross income from U.S. sources which is not effectively connected with the conduct of a trade or business within the United States; and (ii) gross income which is effectively connected with the conduct of a trade or business within the United States. With certain exceptions, compensation for labor or personal services performed in the United States is from sources within the United States. Treas. Reg. § 1.861-4(a)(1). The performance of personal services within the United States constitutes being engaged in a trade or business within the United States. Treas. Reg. § 1.864-2(a). Compensation received by a nonresident alien for performing personal services that constitute being engaged in a U.S. trade or business is income that is effectively connected with the conduct of a U.S. trade or business. Treas. Reg. § 1.864-4(c)(6)(ii).

With certain exceptions not relevant to this case, compensation for personal services performed in the United States is treated as income from sources within the United States, and compensation for personal services performed without the United States is treated as income from sources without the United States. Secs. 861(a)(3) and 862(a)(3),

Section 1.861-4(a) of the Regulations provides that gross income from sources within the United States includes compensation for services performed within the United States regardless of the residence of the taxpayer, the place where the contract for service was made, or the place of payment. See Dillin v. Commissioner, 56 T.C. 228 (1971).

Section 1.861-4(b)(1)(i) of the Regulations provides that when services are performed partly within and partly without the United States, the amount to be included in gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the case. This section further provides that where an apportionment on a time basis is acceptable, the amount to be included in gross income as U.S. source income will be that amount which bears the same relation to the total compensation as the number of days of performance of services within the United States bears to the total number of days of performance of services for which the payment is made. See, e.g., Rev. Rul. 87-38, 1987-1 C.B. 176 (sourcing of compensation received by a professional hockey player in a cross-border league).

For taxable years J and K, taxpayer excluded the compensation he received for Services R and S. He also excluded the portion of the total compensation he received from U.S. Association that bears the same relation to such compensation as the number of days that he contends he worked for Association outside the United States to the total number of days that he contends he worked for Association during the year. For purpose of this calculation, taxpayer included in the total days worked outside the United States the days spent on Services R and S for which he was separately compensated.

The Service disallowed the exclusion claimed by taxpayer for the foreign source portion of the compensation he received from U.S. Association. The basis for this disallowance was that taxpayer had not substantiated that he performed services for Association during all of the portion of each year that he was outside the United States and that on the days for which taxpayer has evidence of performing a service for Association, taxpayer has not established the length of time in which he was engaged in such activity. You suggest that apart from the substantiation issue, in computing the foreign source portion of the compensation received by taxpayer pursuant to the H and J Contracts, taxpayer should not include in the numerator of the fraction the days for which taxpayer performed Services R and S.

As to substantiation, the general rules are that provisions that exempt income from taxation "are to be construed narrowly" (United States v. Centennial Savings Bank, 499 U.S. 573 (1991)); and that the burden of proof is on the taxpayer to show that the requirements imposed by the Code are met in order to be entitled to an exclusion from gross income (New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435 (1934)).

Taxpayer's evidence of his activities outside the United States on behalf of the U.S. Association consists of a letter from the Association that describes the services performed by the Taxpayer while outside the United States. Taxpayer also kept a handwritten diary in which he noted meetings, dinners, and other activities that he contends are related to the performance of services for Association.

You are concerned that taxpayer's diary does not indicate the time spent each day on the Association's business outside of the United States. You suggest that the rule in section 1.871-7(d)(3)(ii)(b) of the Regulations should be applied in this case. This Regulation provides the following:

> The performance of labor or personal services during less than eight hours in any day in the United States shall ... be considered as a fractional part of a day in the United States. The total number of hours during which such services are performed in the United States during the taxable year, when divided by eight, shall be the number of days during which such individual shall be considered present in the United States during the taxable year.

However, this Regulation applies solely to a resident of Canada or Mexico who is in the business of providing transportation service between the United States and the taxpayer's country of residence and who performs personal services in both countries. We do not think it is determinative in the context of the facts and circumstances of this case.

Section 1.861-4(a) of the Regulations explains the exceptions to the general rule that income received by a nonresident alien as compensation for personal services performed in the United States is from U.S. sources. One exception is for nonresident aliens who are in the United States for 90 days or less. Section 1.861-4(a)(2) of the Regulations defines the term "day" as

> [a] calendar day during any portion of which the nonresident alien individual is physically present in the United States.

Further, the same definition is contained in section 1.871-7(d)(3)(i) of the Regulations for purposes of determining whether a nonresident alien is present in the United States for 183 days or more and is, therefore, subject to a 30 percent tax on capital gains under section 871(a)(2). It is our view that the definition of the term “day” in sections 1.861-4(a)(2) and 1.871-7(d)(3)(i) of the Regulations is more relevant to this case than the definition in section 1.871-7(d)(3)(ii)(b) of the Regulations.

As mentioned above, Rev. Rul. 87-38 provides guidance as to the calculation of U.S. source income of a nonresident alien hockey player on a team that is in a cross-border league. In addition to days on which a hockey player performs services for his team in the United States, the revenue ruling provides that

> days spent in the United States between regular season and playoff games are considered as days in which services are rendered in the United States as are days spent in the United States between playoff games.

Thus, we think it is not absolutely required that Taxpayer performed services for Association for 8 hours of each day that he claimed as a day for which he was compensated for services performed outside the United States. The issue of whether the Taxpayer is correct as to the days he claims he performed services outside the United States is factual and depends on the information provided by Taxpayer to substantiate his claim. The evidence submitted by Taxpayer is not insubstantial as to the periods during which he was not performing Services R and S. The evidence is less substantial that while performing Services R and S Taxpayer performed services for Association under the H and J Contracts.
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<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

The question of the amount of Taxpayer’s compensation that is allocable to services performed outside the United States is factual. We cannot say that Taxpayer has not presented some evidence to support his position that because of his renown he was able to perform valuable services for Association outside the United States. We think, however, that taxpayer has offered less evidence that during the time he was being separately compensated for Services R and S outside the United States during Years J and K he was performing services apart from the employment contracts that covered Services R and S. We recommend [redacted]

If you have any further questions, please call (202) 622-3268.

W. EDWARD WILLIAMS
Senior Technical Reviewer