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New Exemptions From Withholding of Federal Income Taxes on Compensation Paid to Nonresident Aliens

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I. INTRODUCTION

Section 1441 of the Internal Revenue Code, and the regulations thereunder, require that all persons paying a nonresident alien individual for personal services must withhold thirty percent of the compensation as a federal tax, if the compensation constitutes gross income from sources within the United States.[1] Both the withholding provisions in section 1441 and the accompanying regulations apply only to compensation received by nonresident aliens from United States sources for services performed as independent contractors.[2] Persons paying a nonresident alien[3] carry the burden of withholding the appropriate amount of compensation. These persons, who are defined as withholding agents by statute,[4]

1. I.R.C. § 1441(a) (1982).
2. *See infra* notes 94-162 and accompanying text.
3. I.R.C. § 1441(a) (1982).
4. Treas. Reg. § 1.1441-7(a) (1984).

are liable[5] to the government for the taxes withheld in accordance with section 1441.

A nonresident alien performing services as an independent contractor may have substantial deductible business and personal expenses,[6] and his effective tax rate is often below the thirty percent withholding rate. To correct the resultant overwithholding and the hardship it places on nonresident aliens, the Treasury Department in 1984 issued amendments to regulation 1.1441-4 that provide nonresident aliens with certain exemptions from withholding on compensation for independent personal services.[7]

The 1984 amendments to the withholding regulations are the latest step in a thirty-year series of developments that have transformed the federal tax withholding provisions applicable to nonresident aliens.[8] These developments have come in the form of both amendments to the Internal Revenue Code and regulations issued by the Treasury Department.[9] Although the 1984 amendments to regulation 1.1441-4 benefit nonresident aliens, they may impose additional burdens and unforseen liabilities on withholding agents which, on balance, mitigate the possible advantages.[10]

II. HISTORY OF WITHHOLDING ON COMPENSATION TO NONRESIDENT ALIENS

The Treasury Department first issued regulations under section 1441[11] in 1956.[12] The Department has amended these initial regulations

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5. I.R.C. § 1461 (1982).

6. *See generally* INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 519, U.S. TAX GUIDE FOR ALIENS 17-19 (Rev. Nov. 1985) [hereinafter U.S. TAX GUIDE FOR ALIENS]. This publication lists and describes the various exclusions, deductions and credits to which nonresident aliens receiving compensation for personal services are entitled. The nonresident alien may exclude from gross income scholarship and fellowship grants and the first $100 of dividends received from United States corporations. Nonresident aliens may deduct from gross income travel expenses, moving expenses, business expenses, losses from transactions entered into for profit, and contributions to an individual retirement account. Nonresident aliens are allowed itemized deductions for casualty and theft losses, charitable contributions and state and local income taxes. In addition, nonresident aliens may claim credits for political contributions, child care and the investment tax credit. *Id.*

7. T.D. 7977, 1984-2 C.B. 185.

8. *See infra* notes 11-93 and accompanying text.

9. *See infra* notes 11-93 and accompanying text.

10. *See infra* notes 182-201 and accompanying text.

11. I.R.C. § 1441 (1982).

12. T.D. 6187, 1956-2 C.B. 567.

during the past thirty years to increase the number of exemptions from withholding available to nonresident aliens and to liberalize the withholding requirements in general.

As initially promulgated, regulation 1.1441-4 listed three exemptions from the withholding requirements under section 1441.[13] The first exemption,[14] which reduced the amount of income subject to withholding, provided that nonresident aliens could deduct section 151[15] personal exemptions on a prorated basis as described in regulation 1.1441-3(e).[16] Specifically, regulation 1.1441-3(e)(2) allowed a nonresident alien to deduct from remuneration for labor or personal services $1.70 per day for the total number of days in a period of employment if, incident to or as part of the employment, any labor or personal services were performed in the United States.[17]

The two other initial exemptions applied only to individuals who entered and left the United States at frequent intervals.[18] One exemption provided that compensation paid to a nonresident alien engaged in agricultural labor[19] was not subject to withholding.[20] The other exemption provided that compensation paid to a resident of Canada or Mexico was not subject to withholding under section 1441, but may be subject to withholding under sections 3401 and 3402 which set forth the withholding scheme applicable to United States citizens.[21]

The regulations under section 3401 and 3402, however, did provide a narrow exemption to the general withholding requirements.[22] Regulation 31.3401(a)(7) exempted remuneration paid to residents of Canada or Mexico who provided transportation service between points in the United States and a contiguous country, and for services rendered in connection with an international construction project, such as the building of a dam or bridge which crossed a United States border.[23]

In 1966 the Treasury Department applied this exemption and held

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13. Treas. Reg. § 1.1441-4, T.D. 6187, 1956-2 C.B. 567, 574.
14. *Id.*, § 1.1441-4(b)(3), 1956-2 C.B. at 575.
15. I.R.C. § 151 (1982).
16. Treas. Reg. § 1.1441-3(e), 1956-2 C.B. 567, 575.
17. *Id.*, § 1.1441-3(e)(2), 1956-2 C.B. at 573.
18. *Id.*, § 1.1441-4(b)(1), 1956-2 C.B. at 574.
19. The regulation stated that the definition of agricultural labor in I.R.C. § 3121(g) applied.
20. Treas. Reg. § 1.1441-4(b)(1)(ii), T.D. 6187, 1956-2 C.B. 567, 574.
21. *Id.*, § 1.1441-4(b)(1)(i), 1956-2 C.B. at 574.
22. Sections 3401 and 3402 set forth the withholding scheme applicable to United States citizens and resident aliens. I.R.C. §§ 3401, 3402 (1982).
23. Treas. Reg. § 31.3401(a)(7)-1, T.D. 6259, 1957-2 C.B. 645, 659.

that Canadian truck drivers who as part of services performed for a Canadian employer entered and left the United States at frequent intervals were completely exempt from withholding.[24] Regulation 31.3401 specifically included remuneration paid to a Canadian or Mexican resident who worked at a fixed, regular location in the United States and who crossed a border as part of a daily commute to work in compensation subject to withholding.[25] The initial regulations issued under section 1441 allowed only three narrow exemptions for the personal exemption, agricultural workers, and residents of Canada and Mexico.

Regulation 1.1441-4[26] was amended in 1957 to provide an additional, although still very narrow, exemption from withholding. The amendment[27] excluded the per diem subsistence payments made by the United States Government to nonresident alien individuals enrolled in the training programs established in the United States under the Mutual Security Act of 1954.[28] The function of the amendment[29] was to make regulation 1.1441-4 conform to provisions in the Mutual Security Act of 1954, and the Internal Revenue Code, as they were both amended by section 11(a) of the Mutual Security Act of 1956.[30] The parallel language amending the code excluded the subsistence payments made by the United States Government to nonresident aliens engaged in training programs under the Mutual Security Act of 1954 from the withholding requirements of section 1441 and regulation 1.1441-1. This relief from withholding reflected the fact that participants in Mutual Security Act programs generally had enough tax deductions to lower their tax liabilities to zero and to entitle them to full refunds of all amounts previously withheld upon their departure from the United States.[31]

The Treasury Department next amended regulations 1.1441-1, -2, -3, and -4 in accordance with the Mutual Educational and Cultural Exchange Act of 1961 (MECEA),[32] which also amended section 1441 of the Internal Revenue Code. Once again, the amendments provided a

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24. Rev. Rul. 66-77, 1966-1 C.B. 242.

25. Treas. Reg. § 31.3401(a)(7)-1(c), T.D. 6259, 1957-2 C.B. 645, 659.

26. Treas. Reg. § 1.1441-4 (as amended by T.D. 6229, 1957-1 C.B. 287).

27. *Id.*

28. Mutual Security Act of 1954, Pub. L. No. 665, 68 Stat. 832.

29. T.D. 6229, 1957-1 C.B. 287.

30. Mutual Security Act of 1956, Pub. L. No. 726, § 11(a), 70 Stat. 555, 563. Section 11(a) added paragraph (6) to section 1441(c) of the Internal Revenue Code.

31. S. REP. NO. 2273, 84th Cong., 2d Sess. 40, *reprinted in* 1956 U.S. CODE CONG. & ADMIN. NEWS 3204, 3242.

32. Mutual Educational and Cultural Exchange Act of 1961, Pub. L. No. 87-256, § 110(d), 75 Stat. 527, 536.

narrow set of provisions for relief from withholding.[33] The changes to section 1441 imposed a reduced withholding rate of eighteen percent,[34] as opposed to the regular rate of thirty percent, on scholarship and fellowship grants received by nonimmigrant nonresident aliens temporarily in the United States.[35] More importantly, MECEA altered section 1441(c)(4) to permit the Treasury Department to issue regulations that would completely exempt from withholding compensation for personal services received by certain student or teacher nonresident aliens.[36]

Elibility standards for the new exemptions required that nonresident alien students or teachers be present in the United States under either of two provisions of MECEA that amended the Immigration and Nationality Act (INA).[37] The amendments to INA expanded one category of nonresident alien to include not only those aliens present in the United States temporarily and solely for the purpose of studying at a United States educational institution, but also the alien's spouse and minor children.[38] In addition, MECEA added section 101(a)(15)(J) to INA,[39] which created a new category of nonresident aliens: alien students or teachers, and their spouses and children, temporarily present in the United States as participants in a program designated by the Secretary of State.[40] MECEA further amended section 1441(c)(4) to allow the Treasury Department to issue regulations that would exempt from withholding nonresident aliens in the expanded category and the new category. The Treasury Department, in turn, issued regulations that amended regulation 1.1441-4(b) to exempt completely from section 1441 withholding compensation for personal services paid to a nonresident alien employee present in the United States under sections 101(a)(15)(F) and 101(a)(15)(J) of the INA.[41]

The conference report accompanying MECEA explained that the purpose of the amendments was to eliminate overwithholding of income,

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33. T.D. 6592, 1962-1 C.B. 160.

34. Mutual Educational and Cultural Exchange Act of 1961, Pub. L. No. 87-256, § 110(d), 75 Stat. 527, 536.

35. *Id.*, § 110(d)(1)-(2).

36. *Id.*, § 110(d)(3).

37. Immigration and Nationality Act, Pub. L. No. 414, 66 Stat. 163 (1952) (codified at 8 U.S.C. §§ 1101-1503 (1982)).

38. Mutual Educational and Cultural Exchange Act of 1961, Pub. L. No. 87-256, § 109(a), 75 Stat. 527, 534 (codified at 8 U.S.C. § 1101(a)(15)(F) (1982)).

39. *Id.*, § 109(b), 75 Stat. at 534 (codified at 8 U.S.C. § 1101(a)(15)(J) (1982)).

40. *Id.*

41. Treas. Reg. § 1.1441-4(b) (as amended by T.D. 6592, 1962-1 C.B. 160).

because it imposes a hardship on nonresident aliens.[42] Overwithholding and the subsequent payment of a refund to the alien after he returned home resulted in sending dollars out of the United States.[43]

Although these amendments mitigated the burden of overwithholding and the sending of dollars overseas to some degree, the Treasury Department's amendments to the regulations were deceptively restrictive. Only "[t]he salary or other compensation for personal services performed by a nonresident alien individual as an employee" was relieved from withholding under section 1441.[44] Such payments were still subject to eighteen percent withholding imposed on all aliens and other sections of the Code.[45] The use of the word "employee" in the amendment also indicates that if payments were made to a nonresident alien as an independent contractor, and not as an employee, the payments would be subject to the thirty percent withholding.[46] Ultimately, these amendments to section 1441 and the accompanying regulations did little to relieve nonresident aliens from withholding.

Congress next amended section 1441(c) with the passage of the Foreign Investors Tax Act of 1966 (FITA).[47] FITA changed the text of section 1441(c)(1) to exempt from withholding any item of income, other than compensation for personal services, that was "effectively connected with the conduct of a [United States] trade or business."[48] FITA also amended section 864(b)(1) of the Internal Revenue Code to expand "trade or business within the United States" to include the performance of personal services within the United States.[49] Simultaneously, the amendments excepted from this definition services performed by a person present in the United States for ninety days or less during the tax year and whose compensation did not exceed $3000.[50]

FITA also incorporated into section 864 rules for determining whether income was "effectively connected with the conduct of a trade or business within the United States."[51] If income were derived from the

42. CONG. REP. NO. 1197, 87th Cong., 1st Sess. 18, *reprinted in* 1961 U.S. CODE CONG. & ADMIN. NEWS 2775, 2781.

43. *Id.*

44. Treas. Reg. § 1.1441-4(b) (as amended by T.D. 6592, 1962-1 C.B. 160, at 161).

45. *Id.*, § 1.1441-3 (as amended by T.D. 6592, 1962-1 C.B. at 162).

46. *Id.*

47. Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 103(h), 80 Stat. 1539, 1553.

48. *Id.*, § 103(h)(5), 80 Stat. at 1553.

49. *Id.*, § 102(d)(2), 80 Stat. at 1544.

50. *Id.*

51. *Id.*, 80 Stat. at 1545.

assets of a United States trade or business, or the activities of the trade or business "were a material factor" in the realization of the income, such income was deemed to be effectively connected to a trade or business within the United States.[52]

The determination of whether income was effectively connected with the conduct of a United States trade or business was significant because FITA amended section 871 of the Code to impose one set of rates on income that was effectively connected, and a different rate on income that was not.[53] Specifically, section 871(a), as amended, established a flat tax of thirty percent on wages, compensations and remunerations received from sources within the United States by a nonresident alien, but only to the extent such receipts were not effectively connected with the conduct of a United States trade or business.[54] Alternatively, section 871(b), as amended, imposed the standard section 1 progressive tax rates on the income of a nonresident alien that was effectively connected with the conduct of a United States trade or business.[55]

FITA completely altered section 1441(c)(4) by removing the former restrictive language which allowed the Treasury Department to exempt from withholding only those aliens who entered and left the United States at frequent intervals or those aliens present in the United States under sections 101(a)(15)(F) and (J) of the Immigration and Nationality Act.[56] FITA substituted the simple language, "[u]nder regulations prescribed by the Secretary or his delegate, compensation for personal services may be exempted from deduction and withholding under subsection (a)" as new section 1441(c)(4) of the Code.[57] The new provision gave the Treasury Department significantly broader power to issue regulations containing exemptions from withholding.

The dual objectives of Congress in passing FITA were to improve fairness in the taxation of nonresident aliens and to provide increased incentives for aliens to invest money in the United States.[58] The amendments to sections 864 and 871 benefited aliens by taxing only income effectively connected with a United States trade or business at progressive rates, and taxing all other income, such as passive investment in-

52. *Id.*
53. *Id.*, § 103(a)(1), 80 Stat. at 1547.
54. *Id.*, 80 Stat. at 1548.
55. *Id.*
56. *See supra* notes 41-54 and accompanying text.
57. Foreign Investors Tax Act of 1966, Pub. L. No. 89-909, § 103(h)(6), 80 Stat. 1539, 1553.
58. S. REP. No. 1707, 89th Cong., 2d Sess. 9, *reprinted in* 1966 U.S. CODE CONG. & ADMIN. NEWS 4446, 4454.

come, at the flat thirty percent rate.[59] Prior law imposed a tax on all income of a nonresident alien at the progressive section 1 rates if the nonresident alien was engaged in a United States trade or business, even if some of the income was not connected with the trade or business.[60] In effect, the identical investment income of two nonresident aliens could be taxed at varying rates because one of the alien investors was also engaged in a United States trade or business.[61] The amendments removed this potential inequity.

Despite these benefits, the 1966 FITA amendments created a confusing and unfair scheme of taxation with respect to compensation paid to a nonresident alien as an independent contractor. This compensation, like other income derived from the performance of services, was generally taxed at a progressive rate.[62] Section 871(b) imposed progressive rates of taxation on income effectively connected with a United States trade or business, which would include income derived from the performance of services in the United States, both as an employee and as an independent contractor.[63] The same compensation was subject to thirty percent withholding under section 1441. Although section 1441(c)(1) excluded income effectively connected with a United States trade or business, which was taxed at progressive rates,[64] section 1441(c)(1) excepted from this exclusion compensation for personal services.[65] In effect, these amendments required that compensation for personal services be taxed at progressive rates, but withheld at the flat thirty percent rate.

Congress intended to correct this disparity by including in FITA the amendment adding section 1441(c)(4) which gave the Treasury Department broad authority to issue regulations exempting compensation from withholding.[66] The Senate Committee on Finance specifically stated that "withholding at the [thirty] percent rate should only be required in the case of income which is taxed at that rate."[67] However, the Committee also reported that regulations issued pursuant to new section 1441(c)(4) were to exempt from thirty percent withholding only salaries and wages

59. *Id.* at 17-25, *reprinted at* 4469-70.
60. *Id.*, at 18, *reprinted at* 4467-68.
61. *Id.*
62. *See* Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, § 102(d)(2), 80 Stat. 1539, 1544.
63. *Id.*, § 103(a)(1), 80 Stat. 1547-48.
64. *See id.*, § 103(h)(5), 80 Stat. at 1553.
65. *Id.*
66. *Id.*, § 103(h)(6), 80 Stat. at 1553.
67. S. REP. No. 1707, *supra* note 58, at 30, *reprinted at* 4475.

paid to nonresident aliens as employees.[68] Such salaries and wages paid to employees were subject to the regular progressive withholding applicable to all United States employees.[69]

The regulations issued under revised section 1441(c)(4) prescribed the limited scope which the Committee intended. The regulations first exempted from withholding under section 1441 income effectively connected with a United States trade or business, except compensation for personal services performed by an individual.[70] They next exempted compensation for personal services of an individual, but only if such compensation was subject to the withholding provisions applicable to United States resident employees.[71] Under these regulations, nonresident aliens working as independent contractors were still subject to thirty percent withholding, and nonresident aliens working as employees were subject to withholding at progressive rates.

Two revenue rulings issued in the 1970s illustrated the inconsistent result produced by FITA and the regulations subsequent to it. The first, Revenue Ruling 70-543,[72] presented the examples of a nonresident alien pugilist and a nonresident alien golfer, both of whom participated in competitions in the United States during the tax year. Both of the athletes incurred expenses for traveling, coaches, equipment and agents, which were fully deductible. Since the boxer and golfer performed services in the United States, they were engaged in a United States trade or business and were subject to progressive tax rates. Both were self-employed individuals and therefore free from wage withholding. The Internal Revenue Service concluded, however, that the gross amount of prize money each athlete earned was subject to withholding at thirty percent, even though it was taxable at progressive rates after an allowance for deductions.[73]

The Internal Revenue Service subsequently expanded its analysis in Revenue Ruling 70-543 by applying it to a self-employed nonresident alien journalist.[74] The journalist was under a contract as a free-lance writer for a domestic news service. Even though the journalist's deductions may have reduced the effective tax on his gross income below thirty percent, the journalist's gross income was subject to withholding at the

68. *Id.* at 30, *reprinted at* 4476.
69. *Id.* at 29-30, *reprinted at* 4475-76.
70. Treas. Reg. § 1.1441-4(a)(1) (as amended by T.D. 6908, 1967-1 C.B. 222, 229).
71. *Id.*, § 1.1441-4(b)(1), (as amended by T.D. 6908, 1967-1 C.B. at 230).
72. Rev. Rul. 70-543, 1970-2 C.B. 172.
73. *Id.* at 174.
74. Rev. Rul. 733-107, 1973-1 C.B. 376.

rate of thirty percent.[75]

The regulations issued following FITA clarified the availability of and means for obtaining an exemption from withholding under a tax treaty.[76] Regulation 1.1441-4(b)(1)(iv) provided that a withholding agent need not withhold income from compensation if such compensation is exempt from the tax imposed by chapter 1 of the Code pursuant to a tax convention.[77] Regulation 1.1441-4(b)(2) instructed a person claiming this exemption to provide the withholding agent with a statement indicating "the provision and tax convention under which the exemption is claimed, the country of which he is a resident, and sufficient facts to justify the claim to exemption."[78] No specific form was prescribed for this statement.[79] Nonresident aliens receiving compensation for personal services both as an employee and as an independent contractor could obtain exemptions from withholding under these provisions. The regulations relating to treaty exemptions provided nonresident aliens who performed independent personal services with greater benefits than previous regulations allowed.

Regulation 1.1441-4(b)(1)(v), issued in 1979, added an additional though limited exemption from withholding to the prior regulations.[80] The regulation provided that compensation paid in the form of a commission or a rebate by a seller of ship supplies to a nonresident alien individual who bought the supplies for use in the operation of a ship were exempt from withholding.[81] To be eligible for this exemption, the nonresident alien individual had to be employed by a foreign citizen, foreign partnership, or foreign corporation, in the operation of a ship of foreign registry.[82]

The Treasury Department issued this regulation in response to a House bill designed to amend section 1441(c) of the Internal Revenue Code to provide this exemption for commissions or rebates.[83] Anticipat-

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75. *Id.* at 377.

76. *See* Treas. Reg. § 1.1441-4(b)(1)(iv)-(b)(2) (as amended by T.D. 6908, 1967-1 C.B. 222, 230).

77. *Id.* § 1.1441-4(b)(1)(iv) (as amended by T.D. 6908, 1967-1 C.B. at 230).

78. *Id.*, § 1.1441-4(b)(2) (as amended by T.D. 6908, 1967-1 C.B. at 230). The statement also required the person's name, address, taxpayer identifying number, certification that he or she was not a citizen or resident of the United States, and certification that the compensation was exempt from the tax imposed by chapter 1 of the Code.

79. *Id.*

80. T.D. 7582, 1979-1 C.B. 287.

81. *Id.*

82. *Id.*

83. H.R. 13336, 95th Cong., 2d Sess., 124 CONG. REC. 19,434 (1978).

ing the Congressional mandate, the Treasury Department relied on the broad grant of authority provided in section 1441(c)(4)[84] and created the new exemption itself.[85] The purpose of the new exemption was "to eliminate the economic disadvantage [to] which U.S. ship suppliers are subjected by virtue of requiring withholding on these commissions."[86] The Department recognized that the amount of these payments was so small that the payments created little or no tax liability, and therefore should not be subject to withholding.[87]

Although the exemption from withholding had only narrow applicability, it was of dual significance. First, the Treasury Department issued the regulation under the broad delegation of regulatory authority prescribed in section 1441(c). In addition, the regulation completely exempted from withholding one form of payments to nonresident aliens for independent services. Thus, while narrowly crafted, the regulation was an indicator of the trend of regulations to follow.

Congress directed the Treasury Department to promulgate further section 1441 regulations with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[88] Section 342 of TEFRA required the Secretary of the Treasury to prescribe regulations that would "ensure that any benefit of any treaty relating to withholding of tax under sections 1441 and 1442 of the Internal Revenue Code of 1954 is available only to persons entitled to such benefit."[89] The House conference report accompanying TEFRA stated that the procedures then in effect for obtaining treaty benefits were insufficient to ensure that United States persons did not pose as aliens entitled to treaty benefits and aliens did not take advantage of a treaty of a country of which they were not a resident.[90]

The conference report suggested the Secretary consider adopting a refund system of enforcement, under which thirty percent of passive investment income would be withheld regardless of any treaty provision. The alien would have to file both a return claiming a refund and "supportive documentation" to obtain any treaty benefit.[91] The conference report also

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84. *See supra* notes 66-69 and accompanying text.

85. T.D. 7582, 1979-1 C.B. 287.

86. *Id.*

87. *Id.*

88. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 342, 96 Stat. 635.

89. *Id.*

90. H. R. REP. No. 760, 97th Cong., 2d Sess. 409, 594, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 1190, 1366.

91. *Id.*

recommended the Secretary consider a certification system, under which an alien would be required to file a certificate of residence from the authority of the country whose treaty the alien is attempting to use.[92] The report gave the Secretary discretion to develop other enforcement methods as well, but required the Secretary to establish the enforcement methods within two years of the enactment of TEFRA.[93] In accordance with Congressional direction, the Treasury Department in 1984 issued new regulations which reformed the requirements for obtaining treaty benefits and created two exemptions from withholding of compensation for personal services.

III. THE NEW EXEMPTIONS FROM SECTION 1441 WITHHOLDING

A. Prerequisites to Applying the Exemptions

Eligibility standards to the exemptions provided by the 1984 regulations,[94] require that the alien's compensation first be subject to withholding under section 1441. Under section 1441 compensation that meets three criteria must be withheld. Specifically, compensation is withheld when paid (1) to a nonresident alien; (2) from United States sources; and (3) for services as an independent contractor.[95]

1. Nonresident Status

Whether a taxpayer is subject to the tax imposed on nonresident aliens by section 871[96] and withholding of that tax required by section 1441[97] depends first on that taxpayer's status as a nonresident alien. Prior to 1984, the taxpayer's status was determined based on the intent of the alien, the presumption that an alien was a nonresident, and any facts and circumstances which might reveal the alien taxpayer's intent. However, in the Tax Reform Act of 1984 (TRA)[98] Congress discarded the old approach and adopted a more objective test for determining an alien's nonresident status.

Prior to 1984, the standards for determining residence rested in part on the observable facts, but primarily on the alien's intent in each partic-

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92. *Id.*

93. *Id.*; *see* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 342, 96 Stat. 635.

94. T.D. 7977, 1984-2 C.B. 185.

95. *See infra* notes 96-162 and accompanying text.

96. I.R.C. § 871 (1982).

97. I.R.C. § 1441 (1982).

98. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 672.

ular instance. A nonresident alien was defined as an individual whose residence was not within the United States, and who was not a citizen of the United States.[99] The regulations defined residence by stating that an alien who was not a transient or sojourner was a resident, and whether the alien was a transient depended on the alien's intentions regarding the length of his stay.[100] A "mere floating intention" to leave the United States did not make an alien a transient, but a definite intent to leave at a specific time did qualify an alien as a transient.[101] There existed a presumption that an alien, "by reason of his alienage," was a nonresident alien.[102] Proof of conduct of the alien showing an intention to become a resident of the United States or showing that the alien's stay has been "of such an extended nature as to constitute him a resident" could overcome the presumption.[103] An alien who came to the United States with a specific purpose which could be promptly accomplished was a transient.[104] Ultimately, therefore, an alien's residency status depended on several subjective factors.[105]

In one case, *Weible v. United States,*[106] the Ninth Circuit considered the taxpayer's intentions, applied the subjective definition of residence to a United States citizen, and held that the individual was a resident of Austrialia for tax purposes. The taxpayer brought action for a refund, claiming eligibility for an exemption from taxation available only to nonresident citizens. He had been sent overseas by a domestic employer to supervise the planning and construction of manufacturing plants and to train personnel to operate the plants. The court found that the taxpayer had established extensive social and business contacts in the countries where he resided.[107] Based on the taxpayer's own testimony, the court also found that he intended to remain overseas for indefinite periods of time at the will of his employer.[108] The majority concluded that the tax-

99. Treas. Reg. § 1.871-2(a), T.D. 6258, 1957-2 C.B. 368, 388.

100. *Id.*, § 1.871-2(b), 1957-2 C.B. at 388-89.

101. *Id.*

102. *Id.*, § 1.871-4(b), 1957-2 C.B. at 389.

103. *Id.*, § 1.871-4(c)(2)(iii), 1957-2 C.B. at 389.

104. *Id.* § 1.871-2(b), 1957-2 C.B. at 389.

105. *See generally* Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 56 (1980); Histrop, *Taxation of Canadian Resident Athletes and Artists Performing in the United States*, 32 CAN. TAX. J. 1060 (1984); Spuehler, *The Foreign Client—A Transactional Approach With Special Emphasis on Nonbusiness Activities—Basic United States Statutory Concepts and United States Treaties*, 24 MAJOR TAX PLAN. 233, 249 (1972).

106. 244 F.2d 158 (9th Cir. 1957).

107. *Id.* at 159.

108. *Id.*

payer was a resident of Australia for tax purposes.[109]

The dissent in *Weible* pointed to several facts that indicated the taxpayer was a United States resident.[110] First, the taxpayer's wife remained in the United States in an apartment which the couple rented together. Second, the taxpayer purchased real estate in Los Angeles while overseas. Third, he maintained both a bank account, into which his monthly paychecks were deposited by his employer, and a club membership while he was absent. Finally, the taxpayer had applied for and obtained an exemption from the Australian income tax based on his statement that his residence was in the United States. The dissent held the taxpayer had no intention to become a resident of any nation other than the United States.[111]

In *Brittingham v. Commissioner*,[112] the Tax Court cited *Weible* in holding that a Mexican citizen who had maintained an apartment and resided in Beverly Hills for over twenty years was a United States resident for tax purposes. The Tax Court stated that the dual requirements of physical presence and a definite intent to make the United States one's home were necessary to establish residence in the United States. The court then merged the requirements by stating that continued presence for a prolonged period is evidence of intent to establish residence.[113] The court also noted that the taxpayer had kept an active checking account in the United States and had filed California state tax returns for some of the years in question.[114] The court held that these facts and the intent evidenced by residence were sufficient to deem the Mexican a United States resident for tax purposes.

In a recent decision, *Park v. Commissioner*,[115] the Tax Court engaged in a thorough review of the regulations and case law regarding residence status and held that a South Korean citizen was a United States resident because of "his deep and continuing involvement in business, personal, social, and political affairs" in the United States.[116] The court, after presenting the facts, described the nature of the residency issue in this way:

> The issue of residency is factual and must be resolved through a consider-

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109. *Id.* at 169.
110. *Id.* at 171 (Lemmon, J., dissenting).
111. *Id.*
112. 66 T.C. 373 (1976).
113. *Id.* at 413.
114. *Id.* at 393-94.
115. 79 T.C. 252 (1982).
116. *Id.* at 289.

> ation of all the relevant facts and circumstances . . . . Because the determination of residency depends so heavily upon the unique personal circumstances of the taxpayer, one case does not always provide reliable guidance for the decision of another. For this reason, the cases relied upon by the parties are of limited value here.[117]

Park, the taxpayer, had attended high school and several universities in the United States prior to the tax years in question. During the years in question, Park had purchased, leased and sold several valuable pieces of residential and commercial property. He had owned controlling interests in a number of corporations. One of these corporations was a nonprofit corporation which operated a Washington, D.C. social club frequented by prominent businessmen and government officials.[118] Park had also maintained numerous United States bank accounts for his business and personal interests.[119] The court found these facts were enough to classify Park as a United States resident. *Park*, *Brittingham*, and *Weible* all called for extensive determinations of fact before residency status could be established.

The need for such examinations of fact and intent was eliminated in 1984 with the adoption of TRA's "substantial presence test"[120] in section 7701(b) of the Internal Revenue Code.[121] The test supplies a purely objective standard for ascertaining an alien's residency status for tax purposes.

Section 7701(b)(1)(B) defines a nonresident alien as an individual that is neither a citizen[122] nor a resident of the United States.[123] Section 7701(b)(1)(A) addresses the more ambiguous definition of residence and prescribes a two-part test by which residency status is established. Meeting either prong of the section 7701 test is sufficient to establish United States residency for purposes of taxation.

The first test states that an alien is a resident if the alien is a lawful permanent resident of the United States.[124] An individual is a "lawful permanent resident" if the individual has been permitted to reside permanently in the United States under immigration laws.[125] This test is

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117. *Id.* at 258-61.
118. *Id.* at 272-76.
119. *Id.* at 268.
120. Tax Reform Act of 1984, Pub. L. No. 98-369, § 138(a)(1)(A)(ii), 98 Stat. 672.
121. I.R.C. § 7701(b)(3) (Supp. II 1986).
122. Citizenship is determined under immigration law, not under the Internal Revenue Code. Dale, *supra* note 105, at 56 n.40.
123. I.R.C. § 7701(b)(1)(B) (Supp. II 1986).
124. *Id.*, § 7701(b)(1)(A)(i) (Supp. II 1986).
125. *Id.*, § 7701(b)(5) (Supp. II 1986).

sometimes called the "green card" test because the alien is issued a permit, or green card, evidencing that he or she is a lawful permanent resident.[126]

The second test for determining residence is the "substantial presence test" under which the Code requires presence in the United States for a specific number of days. To satisfy the test for a given calendar year, the alien must reside in the United States on at least thirty-one days in the current year. In addition, the sum of the number of days the alien is present in the current year, plus one-third the number of days the alien was present in the first preceding year, plus one-sixth the number of days the alien was present in the second preceding year must equal or exceed 183.[127] A person is present in the United States any day such person is physically present at any time during the day.[128] By established objective standards this test has more predictive certainty than the case-by-case approach applied before enactment of the TRA.

The House report accompanying TRA stated that the law should provide a more objective definition of residence for tax purposes.[129] The report applauded the *Park* decision and argued that wealthy individuals who spend substantial amounts of time in the United States and benefit from political stability and economic opportunity in the United States should be taxed by the federal government.[130] The report recognized that an objective definition could be manipulated to obtain tax advantages, but felt that the certainty provided by the definition outweighed other factors.[131] Congress accordingly added the substantial presence test to the Code to provide a definite, objective means for determining an alien's residency status for the purposes of federal income taxation.

2. Compensation from United States Sources

Section 1441 requires withholding on compensation paid to nonresident aliens only to the extent such compensation constitutes gross income from sources within the United States.[132] Section 861 and the regulations elaborating on section 861 provide means to determine whether income is

126. U.S. TAX GUIDE FOR ALIENS, *supra* note 6, at 1.
127. I.R.C. § 7701(b)(3) (Supp. II 1986).
128. *Id.*, § 7701(b)(6).
129. H. R. REP. NO. 432, 98th Cong., 2d Sess. 1523, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1162.
130. *Id.* at 1525, *reprinted at* 1162-63.
131. *Id.* at 1523-24, *reprinted at* 1162-63.
132. I.R.C. § 1441 (1982).

derived from sources within the United States.[133] As several recent cases illustrate, however, determination of source of compensation can be complicated.

Section 861(a)(3) provides that compensation for labor or personal services performed in the United States shall be treated as gross income from United States sources.[134] A statutory exception to this rule occurs when a nonresident alien is present in the United States for less than ninety days during the tax year, he receives less than $3,000 in compensation, and the compensation is paid by a foreign entity or a foreign office of a domestic entity.[135] Regulation 1.861-4 lists numerous conditioning for this de minimus exception, but also states that, in general, compensation for services performed in the United States will be United States source gross income regardless of the residence of the payor, the place where the contract for services was made or the place of payment.[136] In cases when services are performed partly inside and partly outside the United States, the regulation calls for dividing the total compensation by the total number of days worked and treating as United States gross income the compensation for the number of days on which services were performed in the United States.[137] This income will be subject to withholding under section 1441.

The nonresident alien may determine his United States source taxable income using an alternative method prescribed by section 863(b), which applies to income "from transportation or other services rendered partly within and partly without the United States."[138] Under this section, a nonresident alien may calculate his taxable income from all sources by subtracting allowable expenses from gross income from all sources. The nonresident alien must then ascertain what portion of this total taxable income is attributable to United States sources using "processes or formulas of general apportionment prescribed by the Secretary."[139] The section 863(b) process differs from the section 861 process because the section 863(b) process allocates taxable income, while the section 861 process allocates gross income.

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133. *Id.*, § 861 (1982); Treas. Reg. § 1.861-4 (1975). In certain situations, income may be allocated to sources inside and outside the United States, as provided in both section 861 and section 863.

134. I.R.C. § 861(a)(3) (1982).

135. *Id.*

136. Treas. Reg. § 1.861-4(a) (1975).

137. *Id.*, § 1.861-4(b).

138. I.R.C. § 863(b) (1982).

139. *Id.*

In *Metz v. Commissioner*,[140] the Tax Court considered whether compensation received by a nonresident alien from a foreign affiliate of a United States employer for services performed within the United States was United States source income. The taxpayer, a citizen and resident of West Germany, received an $8,000 advance payment from the West German affiliate of his United States employer prior to his departure from West Germany. The taxpayer received approximately $12,000 in compensation from his United States employer for services rendered in San Jose, California. The employer told him that one-third of this was paid by a foreign affiliated corporation. The taxpayer reported $8,000 of income to the IRS, believing the $8,000 received in West Germany and one third of the $12,000 received domestically to be nontaxable foreign source income. The IRS argued that all of the payments received by Metz were taxable income. Relying on section 861(a)(3) and regulation 1.861-4, the Tax Court agreed with the IRS that the $8,000 received in West Germany from the West German affiliate, the $8,000 received from the San Jose employer, and the $4,000 allegedly paid by a foreign payor for services performed in the United States were all United States source compensation.[141]

In Revenue Ruling 76-66[142] and in *Stemkowski v. Commissioner*[143] the Treasury Department and the Second Circuit, respectively, used similar methods of allocating the income of hockey players to United States and Canadian sources, but reached contradictory results. In Revenue Ruling 76-66, the hockey player, a resident and citizen of Canada, was employed by a United States corporation. Before the beginning of the regular hockey season, the taxpayer trained at a facility in Canada where he received per diem compensation not provided for in his contract from the United States employer. The player, under an option offered in his contract, elected to receive his compensation over a twelve month period, which included a period of time during which he was not actually playing hockey for the corporation. The IRS easily decided that the noncontractual per diem payment for training while in Canada came from the location where the training occurred, a non-United States source.[144]

The allocation of the compensation received under the contract, however, required close scrutiny of the contract provisions. Regulation 1.861-

140. 54 T.C.M. (P-H) ¶ 85,035 (1985).
141. *Id.*
142. 1976-1 C.B. 189.
143. 690 F.2d 40 (2d Cir. 1982).
144. 1976-1 C.B. 189, 191.

4(b)[145] provides that compensation attributable to United States sources is determined by applying the ratio of days of performance in the United States over total days of performance to the total compensation. The IRS examined the contract to establish exactly how many days of foreign and domestic performance it required. One provision of the contract provided that a suspended player shall pay as a penalty a portion of his salary based on the ratio of the number of days of suspension to the number of days in the regular hockey season. The regular season did not include the preseason training or the playoffs. A second clause provided that the salary of a player joining the club in midseason would be based on the ratio of days of employment during the season to total days in the regular season. The IRS concluded that these two provisions indicated the contract only covered services during the regular season and did not cover the off-season. The Service ruled, therefore, that the hockey player's United States source income was the portion of total compensation obtained by using the ratio of days of service in the United States to days of service in the regular hockey season.[146]

In *Stemkowski*, a test case that disposed of the claims of forty-one other parties,[147] the Second Circuit used a similar approach to interpret a similar contract, yet reached a different conclusion. Stemkowski, a Canadian resident and citizen,[148] argued that his contract to play hockey for a United States employer required him to perform services throughout the entire year, which included training camp, the regular season, the playoff period and the off-season. He claimed that the United States portion of his compensation should be based on the ratio of days of performance in the United States to days in all four periods of the year. Since Stemkowski lived in Canada during the off-season and training period, this allocation ratio would yield a low United States source income. As in Revenue Ruling 76-66, the IRS argued, and the Tax Court held, that the contract covered services performed only during the regular season, and the allocation should be based on the proportion of days in the United States to days in the regular season.[149]

On appeal the Second Circuit examined the contract and concluded that it required services during training camp, the regular season and the playoff period. Two of Stemkowski's contract provisions were identical

145. *Id.; see supra* notes 136-37 and accompanying text.

146. 1976-1 C.B. 189, 191.

147. 690 F.2d at 42 n.1.

148. *Id.* at 42.

149. *Id.* at 45. This argument agreed with Revenue Ruling 76-66. *See supra* notes 142-46 and accompanying text.

to the suspension provision and the provision for players joining the team in mid-year that the Treasury Department considered in Revenue Ruling 76-66.[150] The court held that these provisions implied that services were required only during the regular season, but were not determinative. The court decided that a provision which required the hockey player to report to the training camp and to play in all playoff games indicated that the contract required services during all periods but the off-season. Because the contract only required that the player remain in good physical condition during the off-season, the court held that no "services" were required during that period.[151] This analysis required that income be allocated to the United States based on the ratio of days of service in the United States to the total number of days in training camp, the regular season and the playoff period. The allocation ratio required by *Stemkowski* is, therefore, lower than the ratio used in Revenue Ruling 76-77, and yields lower United States source income.

As demonstrated by *Stemkowski*,[152] *Metz*,[153] and Revenue Ruling 76-66,[154] a determination of "gross income from sources within the United States"[155] requires careful analysis of contracts and transactions. Income of a nonresident alien which can be attributed to sources within the United States is subject to section 1441 withholding requirements.

3. Services Performed as an Independent Contractor

Section 1441 limits the thirty percent withholding requirement to compensation paid for independent personal services. These services are those performed by a nonresident alien independent contractor as opposed to services performed by an employee.[156] The distinction arises in regulation 1.1441-4(b), which exempts from withholding under section 1441 compensation that is subject to progressive wage withholding under section 3402.

Section 3402, the definitions contained in section 3401, and the regulations thereunder describe what income is subject to progressive wage withholding and not subject to section 1441. Section 3402 requires that

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150. *See supra* notes 142-46 and accompanying text.
151. 690 F.2d at 46-47 (2d Cir. 1982).
152. *See supra* notes 143, 147-51 and accompanying text.
153. *See supra* notes 140-41 and accompanying text.
154. *See supra* notes 142-46 and accompanying text.
155. I.R.C. § 1441(a) (1982).
156. INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 515, WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 9 (Rev. Nov. 1985).

every employer who pays wages must deduct and withhold a tax at a progressive rate that is tied to the amount of the wage.[157] Section 3401(a) defines "wages" as "all remuneration . . . for services performed by an employee for his employer."[158] Regulation 31.3401(d)-1(a) states that an employer is a person for whom an individual performs any service as the employee of such person.[159] Regulation 31.3401(c)-1(a) defines "employee" as every individual performing services if the relationship between the individual and the person for whom the services are performed is the legal relationship of employee and employer.[160] The regulation proceeds to describe the relationship as one in which the person for whom the services are performed has the right to control the individual who performs the services regarding the result to be accomplished and the detail and means by which the result is accomplished.[161] The regulations apparently adopt the common-law standard for determining whether an employment relationship exists. Only payments made to an employee, and not payments made to an independent contractor are, therefore, subject to section 3402 and excluded from section 1441 withholding and the exemptions by the 1984 regulations.

Should an employer-employee relationship exist, all compensation for personal services paid to a nonresident alien is characterized as wages. If compensation is characterized as wages, it will be subject to withholding under section 3402(a), and it will not be subject to withholding under section 1441.[162] Therefore, only compensation paid to a nonresident alien for services as an independent contractor will be subject to section 1441 withholding and eligible for the exemptions provided by the 1984 regulations.

B. Technical Aspects of the New Exemptions

The 1984 regulations revise the existing exemption from withholding based on a tax treaty and provide two new withholding exemptions to nonresident aliens receiving compensation for personal services.[163] The new exemptions allow a nonresident alien either to enter into an agree-

157. I.R.C. § 3402 (1982).
158. I.R.C. § 3401(a) (1982).
159. Treas. Reg. § 31.3401(d)-1(a) (1970).
160. *Id.*, § 31.3401(c)-1(a).
161. *Id.*, § 31.3401(c)-1(b).
162. *U.S. Income Tax Withholding—Foreign Persons*, 341 Tax Mgmt. (BNA) at A-3 (1979); 8 STAND. FED. TAX. REP. (CCH) ¶ 4875.004 (1986).
163. Treas. Reg. § 1.1441-4(b) (as amended by T.D. 7977, 1984-2 C.B. 185, 187-88).

ment with the IRS setting the amount to be withheld from each payment received,[164] or to adjust the amount withheld from the final payment received.[165]

The Treasury Department changed the regulations and created these exemptions to mitigate overwithholding.[166] Overwithholding historically occurred when the section 1441 at the thirty percent withholding rate applied, but the taxpayer's effective rate was lower.[167] The lower effective rate resulted when a taxpayer receiving income effectively connected with a United States trade or business, such as compensation for personal services, deducted the allowable expenses pertaining to the trade or business from gross income and applied the progressive rate of tax in section 1 to the resultant taxable income.[168]

Under the amended regulation 1.1441-4(b) a nonresident alien may obtain an exemption from withholding under a tax treaty to which the alien's country of residence[169] and the United States are parties. The alien's compensation may be exempt from withholding only to the extent that the compensation is exempted by the treaty from the income tax. In order to obtain an exemption, an alien must submit a detailed statement which includes pertinent tax and treaty information to the agent who would ordinarily withhold compensation. The specific form devised by the IRS requires the alien to state: his United States taxpayer identification number and visa number; the name of the country that issued the alien's passport and passport number; the name of the country of which he is a resident; and the tax treaty and provision under which the exemption is claimed.[170] The withholding agent then reviews the statement and decides whether an exemption is warranted.[171] If he is satisfied, he accepts the statement and grants the exemption.[172] The withholding agent, therefore, has significant responsibility in granting the exemption. Unwarranted acceptance of a statement subjects a withholding agent to the penalties of perjury. If the withholding agent accepts the statement and subsequently learns that the nonresident alien is not entitled to the exemption, the withholding agent has the duty to notify the IRS and to

164. *Id.*, § 1.1441-4(b)(3) (as amended by T.D. 7977, 1984-2 C.B. at 189).
165. *Id.*, § 1.1441-4(b)(4) (as amended by T.D. 7977, 1984-2 C.B. at 189).
166. T.D. 7977, 1984-2 C.B. 185.
167. *Id.*
168. *Id.* The Treasury Department believed that the regulatory changes would not reduce compliance with tax laws.
169. Treas. Reg. § 1.1441-4(b)(1)(iv) (1984).
170. Announcement 85-20, 1985-5 I.R.B. 32.
171. Treas. Reg. § 1.1441-4(b)(2)(iii) (1984).
172. *Id.*, § 1.1441-4(b)(2)(iv).

withhold tax from the alien's payments.[173]

The first new exemption to withholding requirements permits the nonresident alien and the Director of the Foreign Operations District of the IRS to enter into an agreement which limits the amount of withholding. In making the agreement which reduces withholding requirements,[174] the alien and the IRS representative consider the nonresident alien's anticipated gross income, personal exemptions, deductible expenses, and rate of tax.[175] Under this new exemption withholding agents are required to comply with the withholding agreement. The nonresident alien is required to file a tax return for the year.[176]

The second new exemption applies only to the final payment of compensation received by a nonresident alien during the taxable year.[177] Under the new regulation, a portion of the final payment up to but not exceeding $5,000 may be exempt from withholding.[178] The nonresident alien receiving a final payment exemption must still file a tax return,[179] and any excess amounts withheld will be refunded upon the filing of the return.[180]

To obtain this exemption, the nonresident alien must submit a statement with specific income information and supporting documents to the District Director of the IRS. Specifically, the alien must submit a separate statement from each person who paid compensation to him which specifies the amount paid and the amount withheld. In addition, the alien must submit a separate document from the person who will make the final payment which states the amount of the payment and the amount that would be withheld if no exemption were granted. The nonresident alien must certify that he or she does not intend to receive any other amounts of gross income during the year. The resident alien may submit his substantiated ordinary and necessary business expenses to be taken into account. Finally, the individual must report the amount of any outstanding tax liabilities in his statement.

After receiving the statement and supporting documents from the nonresident alien, the District Director will determine the individual's tentative tax liability.[181] The District Director will provide the nonresident

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173. *Id.*, § 1.1441-4(b)(2)(iii).
174. *Id.*, § 1.1441-4(b)(3).
175. *Prop. Regs. liberalize withholding for aliens*, 60 J. TAX'N, Feb. 1984, at 110.
176. Treas. Reg. § 1.1441-4(b)(3) (1984).
177. *Id.*, § 1.1441-4(b)(4)(iv).
178. *Id.*
179. *Id.*, § 1.1441-4(b)(5).
180. *Id.*, § 1.1441-4(b)(4)(iv).
181. *Id.*

alien with a letter to give to the person responsible for final payment. This letter will instruct the withholding agent as to how much of the final payment is to be withheld.

IV. ANALYSIS

The 1984 regulations,[182] coupled with the 1984 legislative changes in the Code itself,[183] provide several planning opportunities for nonresident aliens receiving compensation for personal services in the United States. However, when the section 1441 withholding requirements and the sections 861 and 863 rule for allocating compensation to United States sources are both applied to the same compensation, the exemptions provided in the new regulations may serve best as a safe harbor for withholding agents.

The substantial presence test, added to section 7701(b) by the Tax Reform Act of 1984,[184] is an objective and predictable determinant of an alien's residency status. This test, which has yet to be applied, should prove to be of considerable value to a court faced with a residency determination for tax purposes. Rather than repeating the extensive review and weighing of facts of prior cases which offered little guidance,[185] the court may apply a quantitative approach to a residency determination.

Nonresident aliens who receive compensation for services performed in the United States will also benefit from the substantial presence test. Because the test adds certainty to the issue of residency, an alien no longer need fear an unfavorable judicial disposition such as those in *Britingham*[186] and *Park*,[187] in which the courts determined both United States income and worldwide income to be subject to withholding. Implementation of a quantitative test based on number of days present in the United States allows an alien to plan his presence in the United States accordingly. For example, a foreign resident, receiving investment income from overseas sources, could work in the United States for three months annually every year,[188] establish bank accounts, and keep an

182. T.D. 7977, 1984-2 C.B. 185.

183. Tax Reform Act of 1984, Pub. L. No. 98-369, § 138, 98 Stat. 494, 672.

184. *Id.*, § 138(a), 98 Stat. at 672.

185. See the discussion of *Weible, Brittingham* and *Park, supra* notes 106-19 and accompanying text.

186. 66 T.C. 373 (1976); *see supra* notes 112-14 and accompanying text.

187. 79 T.C. 252 (1982); *see supra* notes 115-19 and accompanying text.

188. Under the substantial presence test, *see supra* notes 127-31, an alien may spend three months, or 122 days, each year in the United States and never reach the 183-day residence mark:

apartment in the United States without the threat of a tax imposed on the overseas investment income. Additionally, the substantial presence test will encourage aliens to perform services in the United States because the test makes residency status and tax liability more predictable and controllable.

As illustrated in *Stemkowski*,[189] a nonresident alien can exploit the rules for allocating compensation to foreign and domestic sources to yield tax benefits. The *Stemkowski* decision indicates that courts will review the relevant contract provisions to ascertain where all the services will be performed. The courts will then allocate a portion of the compensation to the United States based on the proportion of total services performed in the United States. This approach prompts nonresident aliens who perform services in the United States to draft their contracts in such a way that they are required to fulfill specific obligations during the period that they live outside the United States. The inclusion of a token obligation to perform services outside the United States insures that a court which reviews that contract will allocate a portion of the compensation to foreign sources.

Although the source allocation rules may help a nonresident alien lower his tax liability, the same rules impose a hardship on a withholding agent attempting to meet his duty to withhold under section 1441.[190] Section 1441 requires a payor to withhold thirty percent of the nonresident alien's gross income from United States sources. Under the allocation rules, however, the portion of compensation that comes from United States sources cannot be determined until the alien performs all services under the contract, both foreign and domestic. Until the contract is completely executed, therefore, the withholding agent cannot determine the total income from which to withhold thirty percent.

The two exemptions provided by the 1984 regulations might help to resolve this problem, since both require the withholding agent to obtain IRS approval before implementation.[191] Under either exemption, the nonresident alien may request that the IRS official examine the service contract along with all the other supporting documentation. The official could then determine the portion of compensation under the contract at-

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	current year		first preceding year		second preceding year
192.9 =	(1 x 122)	x	(1/3 x 122)	x	(1/6 x 122)

189. 690 F.2d 40 (2d Cir. 1982); *see supra* notes 143, 147-55 and accompanying text.

190. Treas. Reg. §§ 1.1441-4(b)(3)-(4) (1984); *see supra* notes 169-73 and accompanying text.

191. *See supra* notes 174-81 and accompanying text.

tributable to United States sources. This decision allows the official to decide the portion of the payments to be withheld under the withholding agreement exemption, or the portion of the final payment to be withheld under the final payment exemption.[192] To a certain extent, determining the exemptions becomes an arbitration process among the IRS, who wants to have thirty percent withheld for compliance purposes, the withholding agent, who wants to fulfill his section 1441 obligations and avoid liability for failure to withhold under section 1461,[193] and the nonresident alien, who wants to receive as much compensation as possible. Ultimately, withholding under a plan endorsed by the IRS may provide the withholding agent with a safe harbor when he cannot access the nonresident alien's gross income from sources within the United States until the contract for services expires or the tax year ends.

The new regulation for obtaining an exemption from withholding under a treaty, regulation 1.1441-4(b)(2), is an improvement over the similar regulation issued in 1966[194] in the aftermath of FITA. The 1984 regulation specifically explains the process for obtaining an exemption under a treaty and imposes strict requirements on an alien seeking a treaty exemption. These new requirements should satisfy the concerns which Congress expressed in TEFRA[195] by insuring that treaty benefits are limited to those entitled to them.

One defect in regulation 1.1441-4(b)(2) is the heavy burden it places on the withholding agent. The withholding agent is required to inspect the application for exemptions and determine whether the nonresident alien is eligible for the withholding exemption.[196] Should the withholding agent know, or have reason to know, that the nonresident alien is, or has become, ineligible for an exemption claimed under a treaty, the withholding agent must withhold payments and notify the IRS.[197] In effect, these provisions make the withholding agent an enforcement agent for the IRS. The responsibilities inherent in the regulation may discourage employers from hiring nonresident aliens. A United States employer may avoid the risk that a nonresident alien will fraudulently claim a treaty exemption and the accompanying risk of liability for failure to withhold simply by not hiring nonresident aliens. Despite certain draw-

192. *See supra* notes 174-81 and accompanying text.

193. Section 1461 imposes liability for taxes not withheld on the withholding agent. I.R.C. § 1461 (1982).

194. *See supra* notes 76-79 and accompanying text.

195. *See supra* notes 88-93 and accompanying text.

196. Treas. Reg. § 1.1441-4(b)(2)(iii) (1984).

197. *Id.*, § 1.1441-4(b)(2)(iii)-(iv).

backs, both the withholding agreement exemption and the final payment exemption benefit nonresident aliens and fulfill the Congressional policy objectives enunciated in FITA.[198] The withholding agreement exemption does, however, call for the IRS to consider certain expenses of the nonresident alien[199] in setting the amount to be withheld from each payment of compensation to be received. This determination would seem to require the nonresident alien to substantiate his deductible expenses before they are incurred. Similarly, the final payment exemption requires the nonresident alien to supply the IRS with highly detailed, documented information that may be difficult to obtain at the outset of a tax period.[200] Furthermore, this exemption caps the amount free from withholding at only $5,000.[201] Although these exemptions have defects, they do allow nonresident aliens to receive more of their compensation for personal services as cash while they are present in the United States. Theoretically, because more cash will reach nonresident aliens while they are present in the United States, more money will be spent for domestically produced goods and services.

V. CONCLUSION

The exemptions available in the 1984 regulations will benefit nonresident aliens receiving compensation for personal services. The exemptions will allow nonresident aliens to receive more of their compensation while they are in the United States, and, in turn, will enable them to spend more of it in the United States. The exemptions are substantially broader and more generous than the narrow exemptions previously available. If a nonresident alien avails himself of the final payment exemption or the withholding agreement exemption, if he is to receive income from United States and foreign sources from one withholding agent, the required negotiations with the IRS may provide much needed guidance to United States withholding agents. If a nonresident alien chooses not to seek an exemption, the withholding agent must use only his own judgment to estimate gross income from United States sources and withhold thirty percent of that amount. Similarly, when a nonresident alien uses the process described in regulation 1.1441-4(b)(2) for obtaining an exemption under a treaty, a withholding agent has few guidelines on which he can rely in deciding to grant the requested exemption. Although the 1984 regulations further Congressional objectives of insur-

198. *See supra* notes 58-69 and accompanying text.
199. *See supra* notes 174-76 and accompanying text.
200. Treas. Reg. § 1.1441-4(b)(4)(iii) (1984).
201. *Id.*, § 1.1441-4(b)(4)(iv).

ing compliance and continue the steady broadening of exemptions from section 1441 withholding requirements, they impose new responsibilities and risks on United States withholding agents who hire nonresident aliens to perform personal services.

Kenneth R. Meyers