Office of Chief Counsel
Internal Revenue Service
Memorandum

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Third Party Communication: None
Date of Communication: Not Applicable

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date: December 12, 2007

to: Deputy Commissioner (International) (SE:LM:IN)
(Office of the Deputy Commissioner (international)

from: Chief, Employment Tax Branch 2, Office of Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)

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subject: Withholding of Income Tax On Remuneration paid to Employees Working outside the United States

This Chief Counsel Advice arose from a request for a private letter ruling submitted by the taxpayer below. The taxpayer withdrew its request for a ruling when we notified its representatives that we intended to rule adversely. This Chief Counsel Advice sets forth our opinion on the issues submitted in the ruling request. In accordance with § 6110(k)(3), this Chief Counsel Advice may not be used or cited as precedent.

Legend:

X =

FC =
FC Tax Authority =
FC Government Official =

The request for a ruling concerned whether certain remuneration paid by the taxpayer (X) to certain employees is subject to United States (federal) income tax withholding under section 3402 of the Internal Revenue Code.

All references to section numbers are to the Internal Revenue Code unless otherwise indicated.

Facts submitted by taxpayer

X is a Delaware limited liability corporation. X represented that it is a partnership for federal income tax purposes. X employs a number of United States citizens and United States resident aliens in a foreign country, FC, for varying lengths of time ("Expatriate Employees"). X represented that none of its employees are partners of X for federal income tax purposes.

The Expatriate Employees' assignments to FC are generally for a period of less than 5 years. Some of the Expatriate Employees qualify or expect to qualify for the section 911 foreign income and housing exclusion. Some United States citizen Expatriate Employees who expect to qualify for the section 911 exclusion may have submitted a completed Form 673, Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911, to X in order to apply to have the employer exclude the applicable amount of compensation from wages for United States federal income tax withholding purposes in accordance with section 3401(a)(8)(A)(i). Form 673, by its terms, does not apply to resident aliens.

Under the current FC income tax procedures, FC income tax (salaries tax) is remitted to the FC Tax Authority using a program of provisional tax payments submitted by the individual employees who are liable for the salaries tax.

X had been advised by counsel in FC that payroll deductions that are not specifically permitted under the FC law are prohibited. X indicated that the deductions permitted under FC law are generally limited to those required by FC law. X stated that all other deductions are prohibited except where FC Government Official, an official in FC Government with jurisdiction over the matter, has given his express approval. X was not aware of any occasion where FC Government Official has approved deductions from wages which are not expressly permitted under FC law. The FC office of X or a related company of X has previously applied to FC Government Official for the approval to withhold wages for payment under an employee stock purchase plan, but approval was denied.

X stated that the prohibition applies to wages as defined under FC law for this purpose or any other sum due to the employee. X acknowledged that the prohibition against withholding under FC law does not apply to annual discretionary bonuses paid to employees, or other amounts that are payable only at the discretion of the employer.

Thus, it is undisputed that FC law does not prohibit the deduction of United States income tax withholding from the discretionary bonuses paid to the Expatriate Employees. Generally, a significant portion of the total remuneration of the Expatriate Employees consists of annual discretionary bonuses.

X represented that if any employer makes a deduction that is not permitted by FC law or which has not otherwise been approved by the FC Government Official, the employer would be subject to a fine or imprisonment. X stated that this liability extends to any director, manager, or other similar officer of a company, or the partner or manager of a firm, where the deduction was made as a result of his/her consent, connivance, or neglect.

X was planning to adopt the following proposed approach ("Proposed Approach") to attempt to comply with both United States and FC laws with regard to the payment of compensation to the Expatriate Employees. Under the Proposed Approach, X would enter into an "agreement" with the FC Tax Authority to obtain an acknowledgement that X is the Expatriate Employee's agent in connection with the purchase of tax reserve certificates ("TRC's") on behalf of the Expatriate Employee. The TRC's would be automatically redeemed by the FC Tax Authority on a "first-in-first-out" basis to settle any outstanding FC tax liabilities for each Expatriate Employee. The FC Tax Authority would automatically redeem the TRC's (purchased on behalf of the specific Expatriate Employee) to pay the FC tax liability of that Expatriate Employee on the tax due date (without involvement of the Expatriate Employee concerned). X believed that under the Proposed Approach X would be replicating a tax withholding system by deducting approximately 16 percent of the Expatriate Employee's gross compensation to purchase TRC's in the same amount for the Expatriate Employee's FC TRC account to satisfy applicable FC tax.

X requested two rulings concerning withholding on the United States citizens and residents working in FC. First, X requested that the Proposed Procedure to be adopted by X will satisfy the requirement of section 3401(a)(8)(A)(ii) that the employer is required by the law of a foreign country to withhold income tax upon such remuneration. X's second ruling request concerns the issue of whether the exception provided by section 3401(a)(8)(A)(i) or (ii) may apply to remuneration for services paid to an individual who is a resident alien and not a United States citizen.

1. Ruling request with respect to whether section 3401(a)(8)(A)(ii) applies to individuals whose remuneration is subject to the Proposed Approach

Section 3402(a) provides that except as otherwise provided in this section, every employer making a payment of wages shall deduct and withhold upon such wages, a tax determined in accordance with tables or computational procedures proscribed by the Secretary. Section 3401(a) defines the term "wages" for purposes of federal income tax withholding as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Section 3401(a)(8)(A), in part, provides for an exception for services for an employer (other than the United States or any agency thereof) --

(i) performed by a citizen of the United States if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excluded from gross income under section 911; or

(ii) performed in a foreign country or in a possession of the United States by such a citizen if, at the time of the payment of such remuneration, the employer is required by the law of any foreign country or possession of the United States to withhold income tax upon such remuneration.

Section 31.3401(a)(8)(A)-1(b)(1) of the Employment Tax Regulations essentially reiterates the language of the statute. Section 31.3401(a)(8)(A)-1(b)(2) provides that remuneration is not exempt from withholding under this paragraph if the employer is not required by the law of a foreign country or a possession of the United States to withhold income tax upon such remuneration. Mere agreements between the employer and the employee whereby the estimated income tax of a foreign country or of a possession of the United States is withheld from the remuneration in anticipation of actual liability under the law of such country or possession will not suffice.

Rev. Rul. 79-392, 1979-2 C.B. 360, concerned whether the exception provided by section 3401(a)(8)(A)(ii) applied under facts described in the ruling. Under the facts of the ruling, consultants performing services in a foreign country are employees of a United States company and continue to receive their salaries from the United States. Pursuant to the laws of the foreign country the remuneration is subject to the foreign country's income tax withholding. However, pursuant to an agreement under the laws of the foreign country between the company and the foreign country's taxing authority, the foreign country will assess the consultants on a direct collection basis. This method provides for an assessment based on the wages earned by an employee in the year prior to assessment and payment in four equal quarterly installments.

Rev. Rul. 79-392 concludes that the agreement between the company and the foreign country to assess the consultants on a direct collection basis is an agreed upon method of complying with a requirement by the foreign country to withhold and is therefore consistent with the language of section 3401(a)(8)(A)(ii). Therefore, the company is not required to withhold income tax under section 3402 on the remuneration of the consultants.

X analogizes its Proposed Approach for funding of TRC's with Rev. Rul. 79-392. However, there is a fundamental distinction between the facts of the revenue ruling and the facts in this private letter ruling request. Under the facts of Rev. Rul. 79-392, the company was required under the law of the foreign country to withhold income tax on the remuneration paid to the consultants. However, FC law does not require

withholding from the remuneration paid to the employees of X. In contrast, it is X's representation that FC prohibits such withholding on wages (as wages is defined for this purpose under FC law) unless there is an agreement between the employer and employee approved by the FC Tax Authority. Therefore, this revenue ruling deals with different facts than the facts present here and does not support the ruling requested.

Under the facts of this ruling request, X's funding of the TRC's through the Proposed Approach would not require X to withhold FC income tax from the wages of the Expatriate Employees within the meaning of section 3401(a)(8)(A)(ii). Furthermore, we are unaware of any amendment to X's Proposed Approach that would require X to withhold FC income tax from the wages of the Expatriate Employees within the meaning of section 3401(a)(8)(A)(ii), in light of X's representation that FC law provides that no withholding of FC income tax is required from the wages of employees.

2. Ruling request with respect to applicability of section 3401(a)(8)(A)(i) or section 3401(a)(8)(A)(ii) to resident aliens

Rev. Rul. 92-106, 1992-2 C.B. 258, provides guidance with respect to withholding of income taxes and other employment taxes on wages paid to United States citizens and residents. In Situation 1 of the ruling, a United States citizen or resident performs services outside the United States, but not in a United States possession, as an employee of a United States person. Situation 2 of the ruling contains the same facts as Situation 1 except that the employer is a foreign person.

Rev. Rul. 92-106 cites the statutory language of section 3401(a)(8)(A)(i) and 3401(a)(8)(A)(ii). After citing these exceptions, the revenue ruling notes that a domestic corporation employing a United States citizen to perform services overseas is not required to withhold on amounts not exceeding in the aggregate, the exclusion the employee is entitled to under section 911, and to the extent the payment exceeds such exclusion, on any payments that are subject to withholding by a foreign jurisdiction.

With respect to Situations 1 and 2, Rev. Rul. 92-106 concludes that amounts of remuneration for services paid to the employee who is a United States citizen are wages for income tax withholding purposes to the extent that they exceed the amount of the exclusion that the employee is entitled to under section 911 and are not subject to withholding under the laws of a foreign country. In the case of wages paid to a United States resident, no exemption from income tax withholding is available for the amount of the exclusion that the employee is entitled to under section 911.

The exception provided by section 3401(a)(8)(A)(ii) directly references the exception provided by section 3401(a)(8)(A)(i) in describing the scope of the application of the exception to United States citizens with the language "by such a citizen." Thus, nothing in the statute suggests that either of the exceptions is intended to apply to anyone other than United States citizens.

In X's ruling request, X cited certain language in the Preamble in T.D. 9276, 71 FR 42049 (July 25, 2006), as supporting its interpretation that section 3401(a)(8)(A)(ii) can apply to remuneration for services paid for services performed by resident aliens. The Preamble in general discusses the comments made with respect to proposed regulations and the changes made in response to the comments. The language X cited is merely describing a comment made with respect to the proposed regulations and does not purport to describe the applicability of the exception provided by section 3401(a)(8)(A)(ii). The Preamble states as follows: "The commenters requested that the regulations provide an exception for United States residents or citizens who are working overseas and receive supplemental wage payments that are subject to foreign income tax, but not foreign income tax withholding." The language from the Preamble including this statement does not provide support for X's interpretation.

There is no authority indicating that the exception provided by section 3401(a)(8)(A)(ii) applies to anyone other than United States citizens. The statute, regulations, and Rev. Rul. 92-108 provide that the exception only applies to remuneration for services performed by a citizen of the United States that meets the requirements of the exception.

3. Summary of our opinion on rulings requested

Thus, with respect to ruling request number 1, we intended to rule that, because FC does not require income tax withholding on the wages of the Expatriate Employees, remuneration paid to the Expatriate Employees does not qualify for the exception provided by section 3401(a)(8)(A)(ii), regardless of whether X enters into the Proposed Approach.

Accordingly, with respect to ruling request number 2, we intended to rule that neither the exception provided by section 3401(a)(8)(A)(i) nor the exception provided by section 3401(a)(8)(A)(ii) applies to remuneration for services performed by an alien individual (whether a resident alien or a nonresident alien). Thus, neither the exception provided by section 3401(a)(8)(A)(i) nor the exception provided by section 3401(a)(8)(A)(ii) can apply to an employee of X who is an alien individual.

Please call (202) 622-6040 if you have any further questions.