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CASE-MIS No.: TAM-115068-09

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Headquarters Office	=
State A	=
Foreign Countries	=
Country X	=
B Airport	=

ISSUES[1]:

1) Gross Income and Income Tax Withholding

Whether wage withholding under Internal Revenue Code (Code) section[2] 3402 or 30 percent withholding under section 1441 applies to remuneration paid by a certified

[1] The TAM initially raised issues with respect to the U.S. taxation of severance which was paid to the NRA flight attendants. However, this issue was subsequently withdrawn.

United States air carrier to nonresident alien (NRA) employees with D-1 visas (or other types of visas) for services the employees perform within the United States.[3]

(a) Whether any remuneration paid to the NRA flight attendants should be apportioned to sources within the United States?

(b) What impact, if any, does the 90-day/$3,000 business visitor exception under sections 861(a)(3) and 864(b)(1) have in determining the U.S. taxation of gross income and wages of the NRA flight attendants?

(c) What impact, if any, does the included-excluded rule provided in section 3402(e) have on the determination of wages of the NRA flight attendants for income tax withholding purposes?

(2) Federal Insurance Contributions Act (FICA)

(a) Whether services by a NRA flight attendant under a contract of service entered into outside the United States are included in the definition of "employment" under section 3121(b) if the services are performed on or in connection with the flight of an American aircraft and if the flight touches a port in the United States?

(b) Whether the included-excluded rule provided by section 3121(c) applies if only a portion of the NRA flight attendant's services are included in the basic definition of employment in section 3121(b) (i.e., the definition contained in the flush language at the beginning of section 3121(b))? Whether Rev. Rul. 79-318, 1979-2 C.B. 352, still represents the IRS position on the issue?

(c) If the services are employment under section 3121(b),

(i) With respect to remuneration for service that is includible in the gross income of the NRA flight attendant, whether such remuneration is includible in "wages" under section 3121(a) and subject to FICA taxes?

(ii) With respect to remuneration for the service that is not includible in the gross income of the NRA flight attendant, whether such remuneration is includible in wages under section 3121(a) and subject to FICA taxes?

(3) Federal Unemployment Tax Act (FUTA)

(a) Whether services by a NRA flight attendant under a contract of service entered into outside the United States are included in the definition of "employment" under section 3306(c) if the services are performed on or in connection with the flight of an American aircraft and if the flight touches a port in the United States?

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code or the regulations promulgated thereunder.

[3] The United States includes airspace over the United States.

(b) Whether the included-excluded rule provided by section 3306(d) applies if only a portion of the NRA flight attendant's services are included in the basic definition of employment in the flush language at the beginning of section 3306(c)? Does Rev. Rul. 79-318 also apply for purposes of the FUTA?

(c) If the services are employment under section 3306(c),

(i) With respect to remuneration for the service that is includible in the gross income of the NRA flight attendant, whether such remuneration is includible in "wages" under section 3306(b) and subject to FUTA?

(ii) With respect to remuneration for the service that is not includible in the gross income of the NRA flight attendant, whether such remuneration is includible in wages under section 3306(b) and subject to FUTA?

(4) Section 530 of the Revenue Act of 1978

Whether section 530 of the Revenue Act of 1978 applies to Taxpayer with respect to its treatment of the remuneration at issue?

CONCLUSIONS:

(1) Gross Income and Income Tax Withholding – Wage withholding under section 3402 applies to remuneration paid by Taxpayer, a certified United States air carrier, to a NRA flight attendant for services performed by the NRA flight attendant within the United States, provided the three prongs of the business visitor exception under sections 861(a)(3) and 864(b)(1) are not met.

(a) U.S. source gross income and wages for services performed in the United States by NRA flight attendants should be determined on a time basis by multiplying the total compensation paid to the NRA flight attendant by the percentage of time the individual worked in the United States during the period to which the compensation relates. The calculation of time worked within and without the United States should take into account all time that the NRA flight attendant is required to report for duty, including pre-flight, post-flight, and training time.

(b) Because the NRA flight attendants are performing services for a foreign office of a domestic corporation, if a NRA flight attendant is present in the United States less than 90 days and has earned less than $3,000 of income from services performed in the United States for the taxable year (the "business visitor exception"), then all of the income earned by the NRA flight attendant in the taxable year is treated as from sources without the United States under section 861(a)(3), and as income not effectively connected with the conduct of a U.S. trade or business under section 864(b)(1), and is not subject to any U.S. income tax withholding. In all other cases, the

portion of the NRA flight attendant's salary apportioned to income from sources within the United States is subject to income tax withholding under section 3402.

(c) The portion of the NRA flight attendant's salary apportioned to sources within the United States is subject to withholding under section 3402 even if it is less than the amount apportioned to foreign sources because the included-excluded rule provided in section 3402(e) does not apply. However, withholding under section 3402 is not required on the NRA flight attendant's salary if all three prongs of the business visitor exception are met during that calendar year.

(2) FICA

(a) Services performed by a NRA flight attendant under a contract of service entered into outside the United States are included in the definition of "employment" under section 3121(b) if the services are performed on or in connection with an American aircraft and if the flight touches a port in the United States.

(b) The included-excluded rule provided in section 3121(c) does not apply when only a portion of the NRA flight attendant's services are included in the basic definition of employment provided in section 3121(b) (i.e., services performed on or in connection with an American aircraft on a flight that touches a port in the United States). Rev. Rul. 79-318 represents the IRS position on the issue.

(c) Remuneration received by a NRA flight attendant for services that are determined to be included in the definition of "employment" under section 3121(b) is wages under section 3121(a) subject to FICA tax whether or not the remuneration is gross income of the NRA flight attendant from sources within the United States. However, remuneration paid to a NRA flight attendant who is a resident of Country X and based in Country X is not subject to FICA tax provided Taxpayer has obtained a certificate of coverage from Country X stating that the services of the NRA flight attendant are covered under the Country X social security system.

(3) FUTA

(a) Services performed by a NRA flight attendant under a contract of service entered into outside the United States are included in the definition of "employment" under section 3306(c) if the services are performed on or in connection with an American aircraft and if the flight touches a port in the United States.

(b)The included-excluded rule provided in section 3306(d) does not apply when only a portion of the NRA flight attendant's services are included in the basic definition of employment in section 3306(c) (i.e., services performed on or in connection with an American aircraft on a flight that touches a port in the United States). Rev. Rul. 79-318 also applies for purposes of the FUTA.

(c) Remuneration received by a NRA flight attendant for services that are determined to be included in the definition of "employment" under section 3306(c) is wages under section 3306(b) subject to FUTA tax whether or not the remuneration is gross income of the NRA flight attendant from sources within the United States.

(4) Section 530 is irrelevant because this case does not involve the issue of worker classification.

FACTS:

Taxpayer is incorporated in the United States and has its corporate headquarters in State A. It engages in the business of providing air transportation on aircraft registered under the laws of the United States. Taxpayer operates through branches or divisions (not subsidiaries) in foreign countries, including certain branches (the "foreign branch offices") in the foreign countries at issue here ("Foreign Countries"). NRA individuals are employed as flight attendants by Taxpayer on its U.S. registered aircraft. The only flights to and from the United States on which the NRA flight attendants are permitted to perform services for Taxpayer are flights that arrive at or depart from the B Airport located in the United States. According to data provided by Taxpayer, substantially all of the flights on which the NRA flight attendants perform services for Taxpayer originate from or terminate at B airport.

The NRA flight attendants perform services as employees within and without the United States in connection with such flights. Thus, it appears that a portion (but less than 50 percent in each payroll period for each employee) of the NRA flight attendants' services is performed within the United States. Also, it appears that less than 50 percent of the remuneration received by the NRA flight attendants in each payroll period is attributable to services performed within the United States. Taxpayer has not withheld or paid United States employment taxes with respect to any of the remuneration paid the NRA flight attendants.

The United States has not entered into income tax treaties with any of the Foreign Countries. The United States has entered into a totalization agreement with Country X which was in effect for the years at issue. The totalization agreement with Country X provides that traveling employees of air transportation companies who perform services in the territories of both contracting states and would otherwise be covered under the laws of both contracting states are, with respect to that work, subject to the laws of only the contracting state in the territory in which the firm has its home office. However, if such employees reside in the territory of the other contracting state, they shall be subject to the law of only that state.

Taxpayer has stated that the labor laws of each of the Foreign Countries specifically prohibit unilaterally withholding taxes other than those imposed by that country.

Some of the Foreign Countries permit agreements between the employer and the employee to have additional amounts withheld from the employee's wages, beyond what is required under the specific country's law.

Taxpayer was audited on the issue of the employment taxation of compensation paid to NRA flight attendants for years prior to the years at issue in this technical advice request. The issue was settled in Appeals, with no employment tax assessment attributable to the compensation for the services performed by the NRA flight attendants.

Hiring, scheduling, training, payroll and benefits for the NRA flight attendants are handled by a combination of Taxpayer's system operations control center located in the United States and branch offices located in the Foreign Countries. Taxpayer's system operations control center located near the Headquarters Office manages the availability of aircraft, the number of crew members assigned to flights, ground employees, and the airspace and facilities. The monitoring systems of the control center account for flight crews' scheduling, time reporting, and paycheck computations. The scheduling of flight crews' work must be coordinated to ensure certain requirements are met for rest periods and maximum flying times. The foreign branch offices do not have independent stand alone scheduling and flight tracking systems. All flight data is fed into one automated system located in the United States to ensure consistency and uniformity. The flight system is based on contractual months set by Taxpayer. During the first half of the month, the system publishes the flight selections for allocations made to the foreign branch office. During the second half of the month, flight attendants may bid for routes through the automated system. Preliminary results of these selections are published and the crew members may resolve any flight sequence conflicts. The foreign branch office will resolve any conflicts not resolved by crew members.

The Local Crew Planner and Local Flight Manager are the individuals responsible for the final schedule, using the data in the global system based in the United States to ensure that Taxpayer's operating needs are met, union guidelines are followed, and Federal Aviation Administration (FAA) regulations are observed. The control center system has to be used to make assignments so employee hours can be monitored for pay purposes as well as for FAA required rest periods and maximum flying times. Taxpayer claims that all decisions about daily business operations, including (relative to the NRA flight attendants at issue) all decisions with respect to which individual employees will be assigned to specific flights, are controlled by the foreign branch offices.

Taxpayer's control center near the Headquarters Office tracks flights and flight crews. Upon arrival at the airport for duty, the NRA flight attendants log into one of the control center's monitoring systems, which records they have reported for their flight. One of the monitoring systems generates flight crew paycheck computations. Since the flight crews are paid based on actual flight time, the actual departure and arrival times are fed

to one of the monitoring systems from the onboard aircraft system. Actual departure and arrival time is based on when the aircraft brakes are released and set. The data from the monitoring system is used for Taxpayer's flight crew payroll for United States nationals and additionally the data is transmitted to the foreign branch office in the Foreign Countries. These offices use this data in their payroll systems to calculate the NRA flight attendants' pay and to process payroll.

Each Foreign Country branch office has local receipts and expenses. Local receipts are from ticket and cargo sales originating from the office's location, and are attributable to transportation on the Taxpayer's U.S. registered aircraft. Taxpayer represents that the cash source for NRA flight attendants' pay is from local ticket and cargo sales. Local receipts are sufficient to cover local expenses in each foreign branch office except for one of the Foreign Countries. Due to high processing costs in that country, credit card sales are processed in the U.S. Taxpayer funds local expenses in that Foreign Country on an as-needed basis from the credit card receipts for that country processed in the United States. Since the foreign branch offices are divisions (foreign branches) of a U.S. corporation, all profits and losses are ultimately borne by the U.S. Corporation.

Payroll checks are issued by and through local payroll systems that are managed by the local controller responsible for the payroll of the branch office. Taxpayer represents that these payroll systems are separate from the U.S. payroll system located in the United States and the foreign payrolls are not funded from the United States. Only local income and social security taxes are withheld. U.S. employment taxes are not withheld. Additionally, NRA flight attendants' health and other benefits, as well as other employment issues are handled by personnel in the foreign branch office; Taxpayer ultimately is responsible for the administration of the health and benefit plans. Taxpayer represents that these plans are not subject to U.S. labor laws and are not subject to any information reporting on Form 5500, Annual Return/Report of Employee Benefit Plan. Each foreign branch office has a full accounting office and the payroll for the NRA flight attendants based in the Foreign Countries is calculated by the local controller from information transmitted from the monitoring system in the United States. The monitoring system reports hours and the controller in the foreign branch office calculates the salary in the local currency. The foreign branch offices print the payroll checks and payroll summaries in three of the countries; in one of the countries, the printing is outsourced to a local contractor.

NRA flight attendants are paid in local currency, and their base pay is computed as a minimum number of hours flight time per month and varies based on the flight time.[4] NRA flight attendants are required to arrive for their flights 90 minutes prior to a flight departing from a Foreign Country and 60 minutes prior to a flight departing from the United States. They are released from their duty 30 minutes after the flight has landed. Taxpayer considers pre-flight and post-flight time as "off the clock" even though the

[4] The NRA flight attendants may be compensated for additional items as provided in the union contracts.

union agreements refer to this time as work or service time. Under the union contract, the NRA flight attendants' base pay is based on flight hours and not on these additional work time hours. Pre-flight and post-flight ground time for all flight attendants is tracked to calculate on-duty maximum hour limitations, which are limited by the FAA. The on-duty period begins at sign in and ends after debriefing.

Taxpayer's NRA flight attendants in the Foreign Countries are represented by local unions. Taxpayer indicates collective bargaining agreements are negotiated with Taxpayer's foreign branch offices in those countries and signed by the branch managers in those countries. Employment contracts are entered into between the foreign branch and the employees in some countries; however, no individual employment contracts are signed in other countries.

Hiring decisions for the NRA flight attendants are made by the branch manager, located in the foreign country, and the regional flight manager and a recruitment specialist, both located in the United States. During the years at issue Taxpayer did not hire any new NRA flight attendants. Taxpayer is required to follow FAA regulations for flight attendant training. Upon recruiting foreign nationals/residents to become flight attendants, Taxpayer provides initial training for them in the United States. If an individual successfully completes the initial training, Taxpayer may offer the individual a position. If an offer of employment is made, a contract of employment between Taxpayer and the foreign national is signed in the foreign national's base country, except in certain of the Foreign Countries where employment contracts are not used. Taxpayer states that during the years at issue, there was no initial training because no flight attendants were hired. As to the number to be hired, Taxpayer has indicated that each year, the Capacity Planning Department determines the number of flights and routes that will be flown. Based on the plan, Crew Resources determines how many flight attendants are needed to work the flight schedule. The Capacity Planning Department and Crew Resources are based in the United States.

Once hired, all of Taxpayer's flight attendants are required to attend annual training in the United States on emergency procedures for FAA certification. Taxpayer's office near the Headquarters Office in the United States is responsible for updating operating procedures for all of its flight attendants in accordance with FAA regulations. Crew Resources in the United States is responsible for deciding when the annual training will occur.

Employee reviews are conducted by the local foreign branch manager. Termination of NRA flight attendants is done by the Foreign Country Flight Service Manager and the Regional Flight Manager in the United States. Neither party has the unilateral authority to terminate a NRA flight attendant without the participation of the other.

LAW AND ANALYSIS:

1) Gross Income and Income Tax Withholding

Section 1441 provides that any person making a payment of compensation or wages constituting gross income from sources within the United States to a NRA individual is required to deduct and withhold from the payment a tax equal to 30 percent thereof (even if effectively connected with a U.S. trade or business).

Section 861(a)(3) provides that generally, compensation received by a NRA individual for personal services performed in the United States is from sources within the United States. Section 862(a)(3) provides that compensation for personal services performed without the United States is income from sources without the United States. These general sourcing rules are subject to the business visitor exception provided in section 861(a)(3) as discussed below.

Section 1.861-4(b)(1) states that if income is derived from personal services performed partly within the United States and partly without the United States, the amount to be included in gross income is determined on the basis that reflects the most proper source of income under the facts and circumstances of the particular case. In many cases the facts and circumstances will support an apportionment on the time basis. In that case, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

Section 1461 states that every person required to deduct and withhold any tax under section 1441 is liable for such tax.

Section 1441(c)(4) provides that compensation for personal services performed by a NRA individual may be exempted from withholding under regulations prescribed by the Secretary. Section 1.1441-4(b)(1) provides that no withholding is required under section 1441 for a payment of compensation that is subject to withholding under section 3402.

Section 3402(a) provides that every employer making payment of wages is required to deduct and withhold Federal income tax withholding according to tables or computational procedures prescribed by the Secretary.

Section 3403 provides that every employer required to deduct and withhold the tax under section 3402 from the wages of an employee is liable for the payment of the tax whether or not it is collected from the employee. *See* section 31.3403-1.

Section 31.3402(d)-1 relieves the employer of liability under section 3403 to the extent the income tax against which the tax under section 3402 may be credited is paid. Such payment does not, however, operate to relieve the employer from liability for penalties or additions to the tax applicable in respect of such failure to deduct and withhold. The employer will not be relieved of his liability for payment of the tax required to be withheld under section 3402 unless he can show that the income tax against which the tax under section 3402 may be credited has been paid.

Section 3401(a) defines wages for the purposes of income tax withholding under section 3402 as all remuneration for services performed by an employee for his employer, with certain specific exceptions.

Section 3401(a)(6) provides an exception from the definition of "wages" for remuneration paid for such services, performed by a NRA, as may be designated by regulations prescribed by the Secretary. The implementing regulations provide detailed rules.

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

Section 31.3401(a)(6)-1(b) provides that remuneration paid to a NRA individual for services performed outside the United States is excepted from wages and hence is not subject to withholding.

Section 31.3401(a)(6)-1(f) provides that remuneration paid for services performed within the United States by a NRA individual after December 31, 2000, is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from the income tax imposed by chapter 1 of the Code by reason of a provision of the Code or an income tax convention to which the United States is a party.

Section 864(b) provides that the performance of personal services within the United States constitutes being engaged in a trade or business in the United States. *See also* section 1.864-2(a). Such performance of personal services does not constitute being engaged in a trade or business in the United States if the business visitor exception applies.

Section 1.864-4(c)(6)(ii) provides that compensation received by a NRA individual for performing personal services that constitute being engaged in a trade or business within the United States is income that is effectively connected to a trade or business if the individual is engaged in a trade or business in the United States at some time during the year in which such income is received.

Section 871(b) provides that a NRA individual engaged in a trade or business in the United States during the taxable year shall be subject to graduated rates of tax as provided in sections 1 or 55 on taxable income which is effectively connected with the conduct of a trade or business within the United States.

Pursuant to section 31.3401(a)(6)-1(a), withholding under section 3402 applies to remuneration paid for services performed by the NRA flight attendants in the United States (unless excluded by the business visitor exception) because the income is from sources within the United States and is effectively connected with the NRA flight attendant's conduct of a U.S. trade or business. *See* sections 861(a)(3) and 864(b)(1) and (c). Because withholding under section 3402 applies, this income is not subject to NRA withholding under section 1441. *See* section 1.1441-4(b)(1). Income which is excluded from section 3402 withholding due to the business visitor exception would similarly be excluded from section 1441 withholding because that income would also be treated as from sources without the United States under the business visitor exception.

The remuneration received by the NRA flight attendant for services performed outside of the United States is excepted from income tax withholding by section 31.3401(a)(6)-1(b). Such income is also excepted from NRA withholding under section 1441 because remuneration for services performed outside of the United States is income from sources without the United States.

1)(a) Whether any remuneration paid to the NRA flight attendants should be apportioned to sources within the United States?

It must first be determined what portion of the NRA flight attendant's wages is remuneration from services performed within the United States and what portion is from services performed without the United States. During the years at issue, section 1.861-4(b)(1) provided that when compensation is paid for services which are performed partly within and partly without the United States, the amount to be included in the gross income shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case. In many cases, apportionment on the time basis is acceptable. Apportioning on a time basis means that the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made.

Rev. Rul. 77-167, 1977-1 C.B. 239, contemplates the appropriate method for allocating compensation for personal services performed by a pilot between sources within and without the United States for purposes of section 911, as in effect in 1977. Citing section 1.861-4(b) the ruling states that the appropriate method for determining the pilot's compensation from sources within the United States is done on a time basis

measured in hourly units. The revenue ruling clarified that the sourcing apportionment under section 1.861-4(b) should take into account all service time required of the pilot, including pre-flight time during which a pilot is required to be present, though such time is not expressly compensated for under the employment contract, since the provision of pre-flight services is necessary, and is thus inextricably connected, to the flight itself.

The Tax Court in Rogers v. Commissioner, T.C. Memo 2009-111, in determining the amount of foreign earned income of a flight attendant, for purposes of section 911, took into account pre- and post-flight time required by the airlines, even though the flight attendant was compensated only for actual flight time.

In Stemkowski v. Commissioner, 690 F.2d 40 (2nd Cir. 1982), the court determined that training time required by a hockey player's contract is work time that should be taken into account when allocating the player's compensation between sources within and without the United States.

The NRA flight attendants in this case perform services while traveling within and without the United States. Compensation is determined based on actual flight time. In addition to the services performed during the flight, the NRA flight attendants are also required to check in prior to the flight, remain for 30 minutes after the flight has landed, and attend annual training conducted in the United States.

Because the remuneration paid to the NRA flight attendants compensates them for services performed both within and without the United States, it is appropriate to apportion between sources within and without the United States on a time basis as provided by section 1.861-4(b)(1). Furthermore, since the NRA flight attendants usually provide services both within and without the United States during a single day, apportioning time on an hourly basis in accordance with Rev. Rul. 77-167 is a method that more accurately reflects source than using a daily basis method.

We note that an alternate basis for apportioning income may be used if that basis is shown to be an equally reliable means of reflecting the source of income under the facts and circumstances. However, Taxpayer has not provided an alternate means of apportioning income that reflects source as accurately as the use of the hourly time basis. Therefore, we conclude that the apportioning on an hourly time basis is the most appropriate method in this case.

With respect to the inclusion of pre-flight, post-flight, and training time, Taxpayer takes the position that the controlling authority for the taxable years at issue is Zimmerman v. Commissioner, 36 T.C. 235 (1961), under which pre-flight and post-flight time was disregarded when determining the amount of income from services performed within Guam. Accordingly, Taxpayer asserts that the position adopted in Rev. Rul. 77-167 and Rogers with respect to pre-flight and post-flight time should be disregarded.

In Zimmerman the Tax Court considered whether a United States citizen who worked as an air navigator based in Guam for flights over international waters was permitted to exclude from gross income a portion of his compensation that he claimed related to services provided while within Guam under section 931, as in effect in 1961. In fact, the Zimmerman court never concluded that time upon which the taxpayer's salary was calculated was the only time to be considered in determining the income from sources within Guam. Instead, the court determined that there was insufficient evidence provided to show that the taxpayer derived 80 percent of his income from within Guam, as required by section 931, as in effect in 1961, and, due to this lack of evidence, could not determine that certain income should be excluded from gross income. Although the court noted that the taxpayer's compensation was based solely on his flying time, not groundwork, and, based on flying time alone, the taxpayer's time in Guam appeared inconsequential, there was no indication that any pre-flight or post-flight time was required by the employer in that case. The court also pointed out that the taxpayer had failed to demonstrate how much time he spent in Guam or what other activities he performed in Guam to earn his salary.

The court's determination that the income from sources within Guam was inconsequential was merely further evidence that the taxpayer had failed to demonstrate that he had met the 80 percent threshold. No such minimal threshold is applicable for purposes of sourcing under section 861, except as provided by the $3,000 prong of the business visitor exception. Consequently, Zimmerman is neither controlling nor relevant in this case.

Rev. Rul. 77-167, on the other hand, does provide clear and relevant guidance that, when allocating between time spent performing services within and without the United States, time which is required of an employee though not separately compensated for, should be taken into account. The Tax Court's subsequent decision in Rogers is further indication that the apportionment method adopted in Rev. Rul. 77-167, rather than the method suggested by the Taxpayer, is the more appropriate one. Similarly, the Second Circuit decision in Stemkowski illustrates that required training or preparation time is work time that is relevant to the determination of services performed within the United States.

Accordingly, pre-flight, post-flight, and training time should be taken into account when determining the amount of U.S. source income from services performed within the United States and the amount of foreign source income from services performed without the United States.

1)(b) What impact, if any, does the 90-day/$3,000 business visitor exception under sections 861(a)(3) and 864(b)(1) have in determining the gross income and wages of the NRA flight attendants?

In general, wages received for performing services in the United States constitutes income from sources within the United States. However, section 861(a)(3)[5] provides an exception to the general sourcing rules for the performance of services by a NRA individual. This exception, known as the "business visitor exception" provides that compensation received by a NRA individual for personal services performed in the United States shall not be deemed to be income from sources within the United States if (A) the services are performed by a NRA individual temporarily present in the United States 90 days or less during the taxable year, (B) such compensation does not exceed $3,000 in the aggregate, and (C) the compensation is for services performed as an employee of a domestic corporation if such services are performed for an office or place of business maintained in a foreign country by such corporation.

Taxpayer argues that none of the NRA flight attendants had U.S. source income that is effectively connected with a U.S. trade or business in the years at issue because every NRA flight attendant satisfied the three-prong test set forth in sections 861(a)(3) and 864(b)(1). Because under Taxpayer's analysis no NRA flight attendant had U.S. source or U.S. effectively-connected income, Taxpayer argues it was under no obligation to withhold U.S. income tax.

As an initial matter, we agree that if a NRA flight attendant meets each prong of the business visitor exception, the remuneration paid to the NRA flight attendant will be treated as foreign source income and, thus, is exempted from U.S. income tax withholding.

To be income from sources without the United States under section 861(a)(3), however, a NRA flight attendant must satisfy each of the three conditions set forth under that section. Whether the NRA flight attendant is providing services for an office or place of business maintained by Taxpayer in a foreign country, as required by section 861(a)(3)(C), is a factual determination. Based on the facts presented, the NRA flight attendants are performing services for offices maintained by Taxpayer in the Foreign Countries. Because we conclude that, for purposes of section 861(a)(3)(C), the NRA flight attendants are performing services for the foreign branch office in which they are based one prong of the business visitor test is met. Therefore, if a NRA flight attendant employed by Taxpayer meets the other two conditions because that individual is present in the United States for 90 days or less, and earns compensation of $3,000 or less, satisfying sections 861(a)(3)(A) and (B), respectively, the compensation of that individual will be considered to be income from sources without the United States and not subject to U.S. income tax withholding. The 90-day and $3,000 prongs of the business visitor test are determined on a case-by-case basis. Following is the relevant law with respect to all three prongs.

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[5] Section 864(b)(1) provides an identical rule for purposes of determining whether a NRA is engaged in a trade or business within the United States. Because the effect of the application of each rule has the same impact on whether amounts in this case will be subject to withholding, we limit our discussion to application of section 861(a)(3), unless otherwise noted.

1)(b)(i) Calculation of days for purposes of section 861(a)(3)(A).

For purposes of the 90-day test under section 861(a)(3)(A) and section 1.861-4(a)(1)(i), section 1.861-4(a)(2) defines "day" as follows:

> (i) As a general rule, the term "day," as used in subparagraph (1)(i) of this paragraph, means a calendar day during any portion of which the NRA individual is physically present in the United States.

Section 1.864-2(b)(2)(i) contains an identical definition of "day" for purposes of the 90-day test of section 864(b)(1) and section 1.864-2(b)(1). Taxpayer argues that the use of the term "as a general rule" must mean that there are exceptions to this definition, such as not counting the day of arrival or aggregating multiple time increments of less than a full calendar day to count as a single day. Although Taxpayer is correct that there can be exceptions to the general definition of a day, those exceptions are extremely narrow. For example, in Rev. Rul. 57-330, 1957-2 C.B. 1013, it was determined that, under the United States-Canada Income Tax Convention, individuals engaged in transportation services that required them to cross the U.S.-Canada border at frequent intervals fell outside the scope of the general definition of "day" and could instead aggregate fractional parts of a day.[6] Accordingly, while there are exceptions to the general rule that physical presence in the United States for any portion of a day constitutes an entire day for purposes of the 90-day test, Taxpayer has not shown that it qualifies for such an exception in this case.

Taxpayer has taken the position that the day of arrival into the United States should not count towards the 90-day threshold test of section 861(a)(3)(A) and section 1.861-4(a)(1)(i), based on Martin Tow v. Commissioner, 36 T.C. 861 (1961). The Tax Court in that decision held that for purposes of section 871(a)(2)(A), the predecessor to section 871(a)(2), the day of arrival should not count but that the day of departure should count. The tax year involved in that case was 1954. That decision has been rendered irrelevant by the promulgation of section 1.871-7(d)(3)(ii), in 1974, and section 1.864-2(b)(2)(i), in 1968, which do not include such a rule. Accordingly, both the day of arrival and the day of departure must count as a day for purposes of the 90-day test in this case.

1)(b)(ii) Apportionment of flight time between sources within and without the United States for purposes of section 861(a)(3)(B).

To determine whether compensation earned by a NRA flight attendant for services performed in the United States is in excess of $3,000, the remuneration paid to the NRA

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[6] We note that this exception applies in other contexts to transportation service workers making multiple trips between the United States and Mexico, as well. See section 1.871-7(d)(3)(ii).

flight attendant should be apportioned between sources within and without the United States in the manner described in Issue 1(a), above.

1)(b)(iii) Whether the NRA flight attendants are providing services for a foreign branch of Taxpayer for purposes of section 861(a)(3)(C).

As stated previously, whether the NRA flight attendants are providing services for an office or place of business maintained by Taxpayer in a foreign country is a factual determination. The relevant inquiry is whether the foreign branch office has sufficient control over the NRA flight attendants to render the flight attendants to be performing services for the foreign branch office for purposes of section 861(a)(3)(C).

This determination involves many of the same factors used to determine whether an individual is an employee for employment tax purposes. Therefore, it is appropriate to utilize, to the extent relevant, the guides for determining the existence of an employer-employee relationship which are found in three substantially similar sections of the Employment Tax Regulations, namely sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the FICA, the FUTA, and federal income tax withholding, respectively. These regulations provide that the relationship of employer and employee generally exists under the common law when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. Accordingly, evidence of both control and lack of control or autonomy must be considered. Relevant facts generally fall into three categories: behavioral controls, financial controls, and the relationship of the parties. It should be noted that the inquiry whether the attendants are performing services for a U.S. office or the foreign branch offices of Taxpayer has no effect on the status of Taxpayer as the employer of the NRA flight attendants for federal employment tax purposes, because the U.S. offices and foreign branch offices are considered parts of the same taxpayer, rather than separate entities. See 1)(d)(iv) of this memorandum.

In the present context, the factors which are particularly significant to the determination, under section 861(a)(3)(C), of whether the NRA flight attendants are performing services for the foreign branch offices rather than directly for a U.S. office of Taxpayer, include the location in which the work is performed, the intent of the parties within the relationship, the office that provides instruction and control over the NRA flight attendants, the office responsible for determining the working hours of the NRA flight attendants, and the office responsible for the hiring, supervision, and discharge of the NRA flight attendants.[7]

[7] Because the test under section 861(a)(3)(C) in this case is whether the NRA flight attendants are working for an unincorporated branch of a U.S. corporation, certain factors that are significant to determining the existence of a common law employment relationship will be less relevant as they are likely to be present in any relationship between a branch and its parent. These factors include requirements regarding the training of the flight attendants in the United States, the provision of tools and

Unlike most employees, flight attendants do not provide services in a fixed location, but rather perform services aboard an airplane which travels through multiple locations. For this reason, the location in which the services are performed is not determinative as to the office for which the NRA flight attendants are considered performing services.

The intent of the Taxpayer to treat the NRA flight attendants as performing services for the foreign branch offices can be evidenced by the union contracts and employment contracts which are entered into by the foreign branch manager, are subject to local law, and often reference the foreign branch office as the party to the contract. Similarly, the fact that payroll for the NRA flight attendants is handled by the accounting offices in the Foreign Countries (or in one case is contracted out to a local payroll service) also evidences the intent that the NRA flight attendants are performing services for the foreign branch offices.[8]

The most significant factors focus on determining which office exerts the most control over the NRA flight attendants. This is evidenced by the active participation of the foreign branch in performance reviews, work hours, hiring, and discharge of the NRA flight attendants. The facts indicate that the foreign branch managers are responsible for reviewing the performance of the NRA flight attendants.

For the most part, work hours are determined through a bidding system which is done on the airline's central control system maintained in the United States. The control system provides an automated process that resolves most conflicts without the involvement of either a U.S. office or the foreign branch offices. However, the foreign branch office has the ultimate responsibility for scheduling the NRA flight attendants from its base and is the party that will resolve conflicts that cannot be resolved via the central control system.

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materials necessary for the flight attendants' services by a U.S. office, and the integration of the employees' services into the business operations of the Taxpayer. Another factor that is less relevant to the present context is responsibility for paying the salaries and expenses of the NRA flight attendants. Although the foreign branch offices have sufficient local receipts to cover the salaries and expenses of the NRA flight attendants and make the payments from the foreign branch, since the foreign branch office is not separately incorporated, the Taxpayer will inevitably bear all expenses of the foreign branch which makes this factor less significant. Other factors used for determining the existence of a common law employment relationship such as whether the individual is full-time, maintains a continuous relationship, and realizes profits and losses, are not relevant for the present inquiry as the current inquiry accepts Taxpayer's representation that the NRA flight attendant are employees of the Taxpayer, and seeks only to establish whether services performed by the NRA flight attendants are performed for the Taxpayer's foreign office for purposes of section 861(a)(3)(C).

[8] Although, the handling of payroll by the foreign branch office is relevant with respect to the intent of the parties, the actual payment of the salaries out of the branch offices' funds is not significant since the expenses will ultimately be borne by the Taxpayer.

Hiring decisions are made by a panel comprised of two supervisors located in the United States and the foreign branch manager. While the foreign branch office initiates the recruitment process through pre-screening, scheduling, and ranking the candidates, the entire panel is involved in making the hiring decision and both offices participate in the initial training of the candidate in the United States, which must be completed before a candidate can be hired. Neither a U.S. office, nor the foreign branch office has the ability to unilaterally hire a candidate who will be based in a Foreign Country.

In a similar manner, decisions to terminate a NRA flight attendant must be made jointly by the regional manager located in the United States and the foreign branch manager. While decisions to fire a NRA flight attendant are generally initiated by the branch manager, the branch manager must consult with the regional manager before terminating the employee.

The IRS Field office has taken the position that the NRA flight attendants do not perform services for the foreign branch offices. This position is based primarily on the following factors, 1) the flight attendants do not perform services within the Foreign Country in which they are based, rather they perform services on an airplane which is owned by the headquarters in the United States and is subject to the control of the pilot who is an employee of the headquarters in the United States, 2) the headquarters is responsible for scheduling the routes for the aircrafts, determining the number of flight attendants required for each flight, and maintains the centralized computer system which the flight attendants use to bid for their hours, and 3) the foreign branch cannot hire or fire the NRA flight attendants without the involvement of personnel from the United States.

We do not agree that these factors are sufficient, or in some cases relevant, to render a decision that the NRA flight attendants are providing services for a U.S. office rather than the foreign branch offices for purposes of section 861(a)(3)(C). The fact that the headquarters owns the aircraft and directs the routes on which the flight attendant provides services does not amount to actual control over the NRA flight attendants for this purpose. Similarly, ongoing programming and maintenance of the centralized computer system does not necessarily equate to decision-making responsibility over the NRA flight attendants' schedules. In fact, to the degree that there is some level of supervision and decision-making authority over scheduling of shifts, the facts indicate that it belongs to the foreign branch manager.

The requirement that the foreign branch office consult with the headquarters prior to hiring or firing personnel is the most convincing argument for the proposition that the NRA flight attendants are not performing services for the foreign branch offices. However, just as the foreign branch offices cannot hire or fire without consulting with personnel in the United States, the personnel in the United States also cannot hire or fire without active involvement of the foreign branch office. When one examines the level of involvement of the foreign branch office and the personnel in the United States in the hiring, performance review, and firing process, including the application of local

labor laws, it appears that the foreign branch office maintains a higher level of involvement.

Thus, upon weighing all of the factors, we conclude that, for purposes of section 861(a)(3)(C), the weight of the evidence points toward a determination that the NRA flight attendants are performing services for the foreign branch offices in which they are based.

1)(c) What impact, if any, does the included-excluded rule provided in section 3402(e) have on the determination of wages of a NRA flight attendant for income tax withholding purposes?

If the business visitor exception does not apply, at least some of the pay a NRA flight attendant receives from Taxpayer for services performed on flights that touch the United States will be U.S. source effectively connected income, and, therefore, wages subject to U.S. income tax withholding. Section 3402(e) contains the included-excluded rule for U.S. income tax withholding purposes. Section 3402(e) provides that if the remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by the employer to the employee for the period is deemed to be wages; but if the remuneration paid by the employer to the employee for services performed during more than one-half of the payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period is deemed to be wages. Although there is no dispute between the IRS field office and the Taxpayer in this case on the application of the included-excluded rule, we set forth the analysis as to why the included-excluded rule in section 3402(e) does not impact this case so as to be clear about the basis on which certain wages paid by Taxpayer to NRA flight attendants are subject to U.S. income tax withholding.

For purposes of applying the rule, amounts paid by Taxpayer to NRA flight attendants that are not U.S. source income are also not wages. *See* section 31.3401(a)(6)-1(b) and Rev. Rul. 79-318, 1979-2 C.B. 352.

Section 31.3402(e)-1(a) provides that for purposes of the included-excluded rule, the relative amounts of time spent performing services that generate section 3401(a) wages and non-section 3401(a) remuneration determine whether all the remuneration for services performed during the payroll period is treated as ”included” or “excluded.” Section 31.3402(e)-1(b) provides that if one-half or more of the employee's time in the employ of a particular employer in a payroll period is spent performing services the remuneration for which constitutes wages, then all the remuneration paid the employee for services performed in that payroll period is deemed to be wages. Conversely, section 31.3402(e)-1(c) provides that if less than one-half of the employee's time in the employ of a particular employer in a payroll period is spent performing services the

remuneration for which constitutes wages, then none of the remuneration paid the employee for services performed in that payroll period is deemed to be wages.

The effect of applying section 3402(e) in cases where less than half of a NRA's remuneration is effectively connected income from a U.S. source, would be to make effectively connected remuneration not subject to wage withholding, and, therefore, subject to 30 percent withholding under section 1441 unless the employee and employer entered into a voluntary withholding agreement under section 3402(p).

Section 1.1441-4(b)(1) requires 30 percent withholding tax on amounts paid to NRAs as U.S. source effectively connected income, unless an exception applies. Section 1.1441-4(b)(1)(i) and (ii) generally provides an exception from section 1441 withholding if the effectively connected income is subject to withholding under section 3402, or would be subject to withholding under section 3402 but for the provisions of section 3401(a) (other than the exception under 3401(a)(6)). Section 1.1441-4(b)(1)(vi) provides an exception from section 1441 withholding if the NRA's U.S. source effectively connected compensation is exempt from withholding under section 3402 because of the included-excluded rule of section 3402(e), provided the employee and his employer enter into an agreement under section 3402(p) to provide for the withholding of income tax upon payments of income described in section 31.3401(a)-3(b)(1) of the regulations. If the section 3402(e) exception applies and a section 3402(p) agreement is in effect, the employer is relieved from withholding under section 1441 and instead withholds under the wage withholding tables that apply for purposes of section 3402.

There was no agreement under section 3402(p) between Taxpayer and any of its NRA flight attendants in this case. Thus, if the compensation were excepted from section 3402 withholding because of section 3402(e), 30 percent withholding under section 1441 withholding would apply.

Withholding on the wages at the 30 percent rate would likely result in overwithholding whereas income tax withholding under section 3402 should more closely approximate the income tax liability of the NRA flight attendant because the NRA flight attendant's effectively connected income is subject to graduated income tax rates by section 871(b)(1) and section 3402 withholding is generally computed under income tax withholding tables that reflect graduated rates.

Legislative history to section 3401(a) indicates an intent to avoid overwithholding under section 1441. Section 3401(a)(6), as presently worded, was added to the Code by section 103(k) of Pub. L. 89-809 to provide for an exception from wages for such services as may be designated by regulations prescribed by the Secretary or his delegate. When this provision was enacted, one of the concerns expressed in the legislative history was that withholding on effectively connected compensation should be at the graduated rates under section 3402 rather than at the 30 percent rate under

section 1441, because the effectively connected income of the NRA is subject to graduated rates of income taxation. See H. R. Report No. 1450, 89th Cong., 2d Sess., 1, 24 (1966); Sen. Rep. No. 1707, 89th Cong., 2d Sess. 1, 30.

Applying the included-excluded rule would exclude remuneration for services performed within the United States (i.e., effectively connected income) from withholding under section 3402 if less than 50 percent of the remuneration was for services performed within the United States. This result would frustrate the intended result of Congress by overriding the intent of section 3401(a)(6), as reflected in the regulations under section 31.3401(a)(6)-1.

Further, the conclusion that the included-excluded rule does not apply in this situation is consistent with a revenue ruling and case law applying the similar FICA rule. See Rev. Rul. 79-318, 1979-2 C.B. 352, and Inter-City Truck Lines, Ltd. v. United States, 408 F.2d 686 (Ct. Cl. 1969), which are discussed more thoroughly in section 2)(b) below. The ruling and the case held that the FICA included-excluded rule was inapplicable in the case of a Canadian truck driver who performed less then one-half of his services within the United States and the remainder of his services outside the United States.

Following the analysis from this case and this ruling, only remuneration for services that is subject to U.S. income tax and is wages for federal income tax withholding (or is one of the enumerated exceptions from wages) is counted in applying the included-excluded rule. This maintains the integrity of the rule that generally, NRAs are not subject to U.S. income tax on remuneration from services performed outside the United States. Rather, the rule applies when the individual has two streams of U.S. source income from the employer – one that is subject to U.S. income tax withholding and one that is not. This approach is reflected in the examples under the section 3402(e) regulations, where the amounts received by the employees (whether included in or excluded from wages) are in either event included in gross income.

1)(d) Taxpayer's Position.

Taxpayer posits several other arguments in addition to the business visitor exception as to why it was not required to withhold U.S. income tax from the remuneration it paid the NRA flight attendants. Each of these arguments is analyzed below.

1)(d)(i) Taxpayer's U.S. income tax withholding liability under section 3402 should not be computed by taking into account the one withholding allowance to which a NRA is entitled when no Form W-4, Employee's Withholding Allowance Certificate, is filed by the NRA flight attendant.

Taxpayer argues that section 31.3402(f)(1)-1(a) provides that a NRA individual is not required to file a Form W-4 to claim a withholding exemption, and therefore, each NRA flight attendant should be treated as having one withholding exemption for purposes of

calculating the U.S. income tax withholding liability of Taxpayer. We disagree with the Taxpayer's interpretation of the relevant legal authority.

Section 3402(f)(1) provides that an employee receiving wages shall on any day be entitled to the withholding exemptions listed in the subparagraphs of section 3402(f)(1).

Section 31.3402(f)(2)-1(a) states that the employer is required to request a withholding exemption certificate from each employee. If the employee fails to furnish a certificate, the employer is to consider such employee as a single person claiming no withholding exemptions.

Section 3402(f)(6) states generally that a NRA individual who is not a resident of Canada or Mexico is only entitled to one withholding exemption.

Section 31.3402(f)(6)-1 provides in effect that generally a NRA individual who is not a resident of Canada or Mexico and who is not a resident of Puerto Rico during the entire taxable year, is allowed under section 3402(f)(1) only one withholding exemption.

Section 3402(l)(1) states for purposes of applying the withholding tables prescribed by sections 3402(a) and (c) to a payment of wages, employees will be treated as single unless there is a withholding exemption certificate furnished by the employee in effect indicating the employee is married.

Section 31.3402(l)-1(c) states that for purposes of sections 3402(l)(2) and 31.3402(l)-1(b) (related to furnishing employer an exemption certificate indicating marital status), an employee will be considered single if either the employee or the employee's spouse is, or on any preceding day within the same calendar year was, a NRA.

Section 31.3402(f)(1)-1(a) provides that except as otherwise provided in section 3402(f)(6) (see § 31.3402(f)(6)-1), an employee receiving wages shall on any day be entitled to withholding exemptions as provided in section 3402(f)(1). In order to receive the benefit of such exemptions, the employee must file with his employer a withholding exemption certificate as provided in section 3402(f)(2).

Taxpayer's argument confuses the difference between entitlement to a withholding exemption or allowance and the necessity for an employee to claim the exemption on Form W-4 to receive the benefit of such exemption. The first sentence of section 31.3402(f)(1)-1(a) merely references the number of withholding exemptions or allowances to which an employee is entitled. It provides that generally an employee is entitled to the exemptions provided in section 3402(f)(1), but a NRA is entitled to only one withholding allowance as provided in section 3402(f)(6). However, the second sentence of section 31.3402(f)(1)-1(a) provides that in order to receive the benefit of any exemptions to which the employee is entitled, the employee must file a Form W-4 with his employer. Taxpayer's interpretation of the regulation is without merit and is

inconsistent with section 31.3402(f)(2)-1(a), which provides that if an employer does not receive a Form W-4 from an employee, the employer is required to treat the employee as a single person claiming no withholding allowances.

It is undisputed that the NRA flight attendants did not file Forms W-4 with Taxpayer. Because the NRA flight attendants did not file Forms W-4, the withholding liability of the Taxpayer, as the employer, for its failure to withhold is computed based on treating each NRA flight attendant as a single person with no withholding allowances.

1)(d)(ii) U.S. income tax withholding liability applies even if foreign law has withholding prohibitions.

Taxpayer argues that foreign law prohibits the withholding of U.S. income tax from the wages paid to the NRA flight attendants, and therefore Taxpayer cannot be liable for the withholding. Nothing in the Code provides an exception from U.S. income tax withholding liability of an employer because of a foreign law prohibiting U.S. income tax withholding.

Section 3401(a)(8)(A)(ii) provides an exception from U.S. income tax withholding for services performed for an employer in a foreign country by a citizen of the United States if, at the time of the payment of such remuneration, the employer is required by the law of any foreign country to withhold income tax upon such remuneration. This exception does not apply in this case because the employees in question are NRAs, not U.S. citizens and because the services in question were performed in the United States, not in a foreign country.

Additionally, the cases cited by Taxpayer have no application to this fact situation. They involve the issue of whether the IRS was permitted to reallocate income between entities under section 482. Commissioner v. First Security Bank, 405 U.S. 394 (1972), and Procter & Gamble Co. v, Commissioner, 961 F.2d 1255 (6th Cir. 1992) were both concerned with the authority provided by section 482 for the Commissioner to reallocate income from one entity to a second entity. When laws prohibited the second entity from receiving the distributions, the courts interpreted this as showing the taxpayers lacked the requisite control under the section 482 regulations that were in effect during the years at issue in those cases. The courts concluded that the reallocation of income under section 482 was not appropriate. The Court stated that "fairness requires the tax to fall on the party that actually received the premiums rather than on the party that cannot." 405 U.S. at 405. These cases are distinguishable. The NRA flight attendants were legally permitted to receive and did in fact receive the income in question. Thus, they are not being subjected to a tax liability without receiving the income.

1)(d)(iii) The Central Illinois "Deputy Tax Collector Defense" does not apply.

Taxpayer argues that it is not liable for U.S. income tax withholding because its obligation to withhold was not clear. This argument arises from Central Illinois Public Service Co. v. United States, 435 U.S. 21, 29-33 (1978), and is also known as the "deputy tax collector defense." In Central Illinois, the Court held that certain travel reimbursements were not wages subject to U.S. income tax withholding under section 3401(a). That holding turned on the fact that, during the relevant tax year, neither the Code, nor regulations, nor any administrative pronouncement required income tax withholding on any travel expense reimbursements. Id. at 25, 32. In contrast, if the Code, a regulation, administrative guidance, or case law puts an employer on notice of its obligation to withhold, then the employer is liable for the withholding. *See* North Dakota State Univ. v. United States, 255 F.3d 599, 609 (8th Cir. 2001) (rejecting Central Illinois defense against liability where revenue ruling provided sufficient notice). In asserting this defense, the taxpayer bears the burden of demonstrating that their obligation to withhold was speculative.

In the instant case, Taxpayer's obligation to withhold was clear from regulations and other published guidance. Section 31.3401(a)(6)-1(a) provides that income tax withholding under section 3402 applies to remuneration for services paid to NRA employees if such remuneration is effectively connected with the conduct of a trade or business in the United States. Also, section 31.3402(f)(2)-1(a) provides that if an employer fails to obtain a Form W-4 from an employee, the employer must withhold U.S. income tax based on treating such person as single with no withholding exemption. As discussed above, Taxpayer's argument that an employer may treat a NRA as having one withholding exemption when no Form W-4 is filed is contradicted by section 31.3402(f)(2)-1(a) and is also inconsistent with section 31.3402(f)(1)-1(a).

Any uncertainty that may have existed about the application of section 3402(e) would not justify a total absence of withholding. Taxpayer had to take a position on the potential application of the included-excluded rule of section 3402(e) to U.S. source income paid by Taxpayer. If the included-excluded rule applied, then Taxpayer should have withheld under section 1441 because Taxpayer had not entered into voluntary withholding agreements with the NRA flight attendants. If the included-excluded rule did not apply, then Taxpayer should have withheld under section 3402.

The IRS has published specific guidance concerning the determination of the U.S. source income of NRA flight personnel. *See* Rev. Rul. 77-167 discussed above. Taxpayer may disagree with the specific guidance, but the guidance was available.

Taxpayer argues that it may rely on the IRS Appeals settlement of the income tax withholding issue for a prior period in determining the correct income tax withholding to be applied to the remuneration paid the NRA flight attendants. However, an Appeals settlement does not change the law. An Appeals settlement may reflect many items that are unrelated to the particular legal issue settled (for example, the strength of

unrelated issues that are part of the settlement and hazards of litigation driven by factors other than the relative strength of the competing legal arguments).

There were factual disputes between the IRS Field office and Taxpayer about whether the NRA flight attendants qualified for the business visitor exception. However, the "deputy tax collector defense" is based on lack of clarity of IRS guidance, not whether there are factual disputes in applying the guidance. Thus, the existence of factual disputes is not a basis for applying Central Illinois.

In summary, Central Illinois does not apply in light of the regulations and revenue ruling issued by the IRS which establish the U.S. income tax withholding liability of the Taxpayer.

1)(d)(iv) The foreign branches of Taxpayer are not employers under section 3401(d)(1).

Taxpayer argues that because the foreign branches of Taxpayer had control of the payment of wages to the NRA flight attendants, Taxpayer is not liable for employment tax payments with respect to any wages paid to the NRA flight attendants. Taxpayer is claiming that its branches in the Foreign Countries are section 3401(d)(1) employers.

Section 3401(d)(1) provides that for purposes of income tax withholding, the term "employer" means the "person" for whom an individual performs or performed any service of whatever nature as the employee of such person except that –

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a), concerning the definition of wages) means the person having control of the payment of wages.

Neither the FICA nor the FUTA contains a definition of employer similar to the definition contained in section 3401(d)(1). However, Otte v. United States, 419 U.S. 43 (1974), holds that a person who is an employer under section 3401(d)(1), relating to income tax withholding, is also an employer for purposes of FICA withholding under section 3102. The Otte decision has been interpreted to provide that the person having control of the payment of wages is also an employer for purposes of section 3111 (the FICA employer tax) and section 3301 (FUTA tax). In re Armadillo Corp., 410 F.Supp. 407 (D. Colo. 1976), aff'd, 561 F.2d 1382 (10th Cir. 1977).

Section 7701(a)(1) provides that where not otherwise distinctly expressed or manifestly incompatible with the intent thereof – the term "person" shall be construed to mean and include an individual, trust, partnership, association, company or corporation.

Section 31.3401(d)-1(c) provides that an employer may be an individual, a corporation, a partnership, a trust, an estate, a joint stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated group or entity.

Section 31.3401(d)-1(f) provides that if the person for whom the services are or were performed does not have legal control of the payment of the wages for such services, the term employer means (except for the purpose of the definition of wages) the person having such control.

Section 3401(d)(1) has no application to Taxpayer's situation because the foreign branch offices and the headquarters office are all part of one person, Taxpayer, which is a corporation. The branch offices are not separate legal entities from Taxpayer. Branch offices should be contrasted with subsidiaries, which are separate legal entities and separate persons. Thus, in this case, Taxpayer is both the person for whom the services are performed and the person in control of the payment of the wages. Thus, Taxpayer is the employer for purposes of U.S. income tax withholding.

The cases cited by Taxpayer are inapplicable. None of the cases treats a branch (or part) of the corporation as a separate section 3401(d)(1) employer from the corporation. In Winstead v. United States, 109 F.3d 989 (4th Cir. 1997), the court was considering which of two unincorporated individuals (a landowner or a sharecropper), and thus separate persons, was the employer under section 3401(d). Also, in General Motors Corp. v. United States, 1990 WL 259676 (E.D. Mich. 1990), the issue was whether General Motors Corp. or a separate overseas company was the employer. Neither case provides authority for the proposition that a branch of a corporation is a separate person or can be treated as an employer apart from the corporation.

2) FICA

Section 3101 imposes FICA tax on employees and section 3111 imposes FICA tax on employers. Section 3101(a), which imposes the employee portion of the old-age, survivors, and disability insurance (social security) tax, and section 3101(b), which imposes the employee portion of hospital insurance (Medicare) tax, both contain the following identical language:

> there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b))….

Section 3101(a) provides that the tax imposed by section 3101(a) is "[i]n addition to other taxes," and section 3101(b) provides that the tax imposed by section 3101(b) is "in addition to the tax imposed by" section 3101(a).

Section 3111(a) and (b), which impose the employer portion of the social security and Medicare tax, respectively, each contain the following language:

> there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))…

Section 3121(a) defines wages for purposes of the FICA as all remuneration for employment, with certain specific exceptions.

2)(a) Whether services performed by the NRA flight attendants are employment for FICA purposes?[9]

Taxpayer does not dispute that the services performed by the NRA flight attendants on flights that touch a port in the United States fall within the definition of employment in section 3121(b) for purposes of the FICA. Nevertheless, it is necessary to set forth the explicit statutory language enacted by Congress as a foundation to understand why we reject Taxpayer's arguments that not all the remuneration for services in connection with those flights is subject to FICA.

Section 3121(b) provides that, for purposes of the FICA, the term "employment" means any service of whatever nature, performed (A) by an employee for the person employing him, irrespective of the citizenship or residence of either, (i) within the United States, or (ii) on or in connection with an American vessel or American aircraft under a contract of service which is entered into within the United States or during the performance of which and while the employee is employed on the vessel or aircraft it touches a port in the United States, if the employee is employed on or in connection with such vessel or aircraft when outside the United States, or (B) outside the United States by a citizen or resident of the United States (effective for remuneration as an employee for an American employer (as defined in section 3121(h)), or (C) if it is service, regardless of where or by whom performed, which is designated as employment or recognized as equivalent to employment under an agreement entered into under section 233 of the Social Security Act.

Thus, this definition of employment includes service performed by an employee for the person employing him, irrespective of the citizenship or residence of either, in connection with a flight of an American aircraft that touches a port in the United States. Employment under this definition includes services performed both inside and outside the United States. This definition includes substantially all the services performed by the NRA flight attendants in this case.

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[9] Due to the similar statutory structure of the FICA and the FUTA, our analysis in sections 2)(a), 2)(b), and 2)(c)(i) and (v) applies equally with respect to the FUTA tax.

If a NRA is working on an aircraft that is not an American aircraft, the services captured by the section 3121(b) definition of employment would include only services that are performed within the United States. However, these services would be excepted from the definition of employment by section 3121(b)(4), which provides an exception for service performed by an individual on or in connection with a vessel not an American vessel, or on or in connection with an aircraft not an American aircraft, if (A) the individual is employed on and in connection with such vessel or aircraft, when outside the United States and (B)(i) such individual is not a citizen of the United States or (ii) the employer is not an American employer. The section 3121(b)(4) exception shows that Congress created FICA rules specific to service on vessels or aircraft that move in and out of the United States and that it made those rules differ significantly based on whether the aircraft or vessel in question is an American aircraft or vessel.

In addition to the explicit statutory language contained in section 3121(b), the regulations also support the position that all services performed on flights touching a port in the United States by Taxpayer's NRA flight attendants are included in the definition of employment for purposes of the FICA. Section 31.3121(b)-3(c)(2)(i) provides that service performed by an employee for an employer "on or in connection with" an American vessel or aircraft outside the United States constitutes employment if three requirements are met.

(a) The employee is also employed "on and in connection with" such vessel or aircraft when outside the United States; and

(b) The services are performed under a contract of service, between the employee and the employer, which is entered into within the United States, or during the performance of the contract under which the services are performed and while the employee is employed on the vessel or aircraft it touches at a port within the United States; and

(c) The services are not excepted under section 3121(b).

In this case, these three requirements are satisfied when the NRA flight attendant is performing services on a flight between B Airport and a Foreign Country.

Section 31.3121(b)-3(c)(2)(ii) provides that an employee performs service on and in connection with the vessel or aircraft if he performs services on such vessel or aircraft. The regulation further provides that services performed on the aircraft by employees as officers or members of the crew of the aircraft are performed on and in connection with such aircraft.

Section 31.3121(b)-3(c)(2)(iii) provides that if services are performed by an employee "on and in connection with" an American vessel or American aircraft when outside the United States and the conditions listed in paragraph (c)(2)(i) (b) and (c) of this section

are met, then the services of that employee performed on or in connection with the vessel or aircraft constitute employment. The expression “on or in connection with” refers not only to services performed on the vessel or aircraft but also to services connected with the vessel or aircraft which are not actually performed on it (for example, shore services performed as officers or members of the crew, or as employees of concessionaires, of the vessel).

Section 31.3121(b)-3(c)(2)(iv) provides that services performed by a member of the crew or other employee whose contract of service is not entered into within the United States, and during the performance of which and while the employee is employed on the vessel or aircraft it does not touch at a port within the United States, do not constitute employment under this subparagraph, notwithstanding services performed by other members of the crew or other employees on or in connection with the vessel or aircraft may constitute employment.

This regulation indicates that the services of the NRA flight attendants on or in connection with an American aircraft that does not touch a port within the United States are not included in the definition of employment. Information submitted in this case indicates that only a relatively small percentage of the flights worked by the NRA flight attendants do not touch a port in the United States.

Section 31.3121(b)-3(c)(2)(v) provides, in part, that an aircraft includes every description of craft, or other contrivance, used as a means of transportation through the air. In the case of an aircraft, the term “port” means an airport. An airport means an area on land or water used regularly by aircraft for receiving or discharging passengers or cargo.

Section 31.3121(f)-1(b) provides that the term “American aircraft” means any aircraft registered under the laws of the United States.

Section 31.3121(b)-3(c)(2)(vi) provides that with respect to services performed outside the United States on or in connection with an American vessel or American aircraft, that citizenship or residence of the employer is material only in case it has a bearing in determining whether a vessel is an American vessel.

The legislative history of section 3121(b) also makes clear that the definition of employment was intended to include services performed outside the United States. *See* Senate Rep. No. 1669, 81st Cong, 2d Sess., pages 131-132 (1950), which states: “…The definition of employment is extended to include services on or in connection with an American aircraft to the same extent as service already included in the definition on or in connection with an American vessel. With respect to service performed on or in connection with an American vessel or American aircraft where the contract of service is entered into outside the United States, your committee has made a clarifying amendment which expressly required that, in order that the services constitute

employment, the employee be employed on the vessel or aircraft when it touches at a port within the United States at some time during the performance of the contract of services."

In summary, the statute, regulations, and legislative history support the conclusion that, because the NRA flight attendants are working on American aircraft, all the services they perform on or in connection with flights that touch a port in the United States are included in the definition of employment for purposes of the FICA, regardless of where the services are performed.

2)(b) Whether the included-excluded rule of section 3121(c) applies with respect to the services performed by the NRA flight attendants?

Section 3121(c) contains the FICA included-excluded rule. Section 3121(c) provides in relevant part that for purposes of the FICA, if the services performed during one-half or more of any pay period by an employee for the person employing him constitute employment, all the services of such employee for such period shall be deemed to be employment; but if the services of such employee during more than one-half of any such pay period by an employee for the person employing him do not constitute employment, then none of the services of such employee for such period shall be deemed to be employment. Although there is no dispute between the IRS Field office and the Taxpayer in this case on the application of the included-excluded rule, we set forth the analysis so as to be clear about the basis on which certain wages paid by Taxpayer to the NRA flight attendants are subject to FICA.

The significant question is whether the services performed by NRA flight attendants that do not fall within the section 3121(b) definition of employment (i.e., services performed on flights that do not touch a port in the United States) should be counted for purposes of applying the included-excluded rule.

Rev. Rul. 79-318, 1979-2 C.B. 352, provides the IRS position on this issue. Under the facts of the ruling, Canadian citizens, who were working as employees of a Canadian employer, performed services as truck drivers partly within and partly outside the United States. In every pay period each employee performed services for less than one-half of the pay period within the United States. The performance of services in Canada by these workers was not included in the section 3121(b) definition of employment and thus, was not excepted by one of the enumerated exceptions from employment provided in sections 3121(b)(1) through (20). The performance of services in Canada was not employment because the services were performed outside the United States. In the ruling, the language in the definition of employment including services performed on or in connection with an American vessel or an American aircraft is not implicated.

The ruling concludes that the included-excluded rule does not contemplate the services performed by the Canadian truck drivers in Canada. The ruling states that the included-

excluded rule in section 3121(c) applies only to services that are performed either within the United States or outside the United States by a U.S. citizen for an American employer and are included or excluded based on the various specific exceptions provided in section 3121(b). The ruling goes on to state that since services performed outside the United States by a foreign citizen for a foreign employer do not fall within the scope of this included-excluded rule, section 3121(c) does not apply to the facts of the revenue ruling. Under the ruling's holding, the included-excluded rule also does not consider the services performed in this case by the Taxpayer's NRA flight attendants that are not included in the definition of employment for purposes of determining the percentage of excluded employment.

The holding in Rev. Rul. 79-318 is consistent with the Court of Claims case, Inter-City Truck Lines, Ltd. v. United States, 408 F.2d 686 (Ct. Cl. 1969). That case was cited in Rev. Rul. 79-318 and has similar facts as the revenue ruling. A Canadian trucking corporation employed Canadian citizens as truck drivers who made deliveries and pick up of shipments in the United States. Under the stipulated facts, services performed inside the United States made up less than one-half of each employee's services during all pay periods in issue. The question presented was whether the periods of employment in the United States was taxable "employment" for FICA purposes. The court held that the trucking company was subject to FICA taxes on the remuneration paid for services performed within the United States "irrespective of what percentage of employees' total service in this country and Canada was performed within the United States." 408 F.2d at 689.

The court's decision was based on several different rationales. The court reasoned that section 3121(c) must be considered in its context in section 3121, immediately following the definition of employment and the exceptions from employment enumerated in the paragraphs of section 3121(b). "We interpret section 3121(c) to apply only to 'services' which are included or excluded in § 3121(b)…." 408 F.2d at 687.

The court also relied on the legislative history relating to section 3121(c). Section 3121(c) was added by section 606 of the Social Security Act Amendments of 1939. The court states that "[t]he section was sponsored by the Social Security Board on behalf of the Board and the Treasury purely as a device to ease administration where the same employee does two kinds of work for the same employer." 408 F.2d at 687. The court quotes from a statement of the Chairman of the Social Security Board before the House Ways and Means Committee that the amendment was to clarify "the law regarding the services of employees who perform both included and excluded employment, the suggestion being that the major portion of his time shall determine whether all of his time shall be considered as having been devoted to excluded or included employment." Under the amendment, "employers who are engaged partly in an excluded and partly in an included occupation may have a standard to report on these employees." 408 F.2d at 687. (Emphasis added by court.)

The court also cited the contemporaneous construction of the statute by the Bureau of Internal Revenue (predecessor of IRS) as support for the court's position. S.S.T. 402, 1940-2 C.B. 252, concerned the issue of whether services performed within the United States by personnel of an airline on flights operating between foreign and U.S. airports were included in employment and subject to FICA taxes. (At the time of issuance, the definition of employment was different from the current definition in that the clause including in employment under certain conditions services on or in connection with an American vessel did not include services on or in connection with an American aircraft.) The court quoted the following language from S.S.T. 402, concerning the included-excluded rules of section 1426(c) of the Internal Revenue Code of 1939 (the predecessor of section 3121(c) of the 1954 Code) and section 1607(d) of the 1939 Code (the predecessor of section 3306(d), the included-excluded rule in the FUTA):

> In the opinion of the Bureau, sections 1426(c) and 1607(d)…were not intended to include as 'employment' services performed outside the United States or to exclude from 'employment' services performed within the United States on the basis of the relations in quantity of services performed both within and without the United States. Accordingly, it is held that such sections are not applicable with respect to the services performed by the flight personnel of the M air lines.

The court noted that if it accepted the literal interpretation of section 3121(c) advanced by the taxpayer applying the included-excluded rule in this situation and if the Canadian citizen truck driver worked 51 percent of his services within the United States during a payroll period, the services of the Canadian citizen truck driver performed in Canada for the Canadian employer would be included in the definition of employment for purposes of the FICA. The court stated that such a result was not "the intent of the Social Security Act." 408 F.2d at 688.

Following the analysis from Inter-City Truck Lines and Rev. Rul. 79-318, only remuneration for services that are included in employment for purposes of FICA is counted in applying the included-excluded rule. This maintains the integrity of the rule that generally, NRAs are not subject to FICA tax on remuneration for services performed wholly outside the United States. As noted by the court in Inter-City Truck Lines, it is doubtful the FICA and Social Security Act, through the included-excluded rule, were intended to provide coverage for services performed exclusively in a foreign jurisdiction by a foreign person that are not in connection with an American aircraft or an American vessel and not included in the definition of employment. Congress intended to provide social security coverage to NRAs only on the services specifically included in the definition of employment and not otherwise excepted. In the instant case, because the great majority of the NRA flight's attendants' services were performed on flights that touch a port in the United States, application of the included-excluded rule would operate to include in employment services performed by the NRA flight attendants on flights between airports in the Foreign Countries that are not included in the basic definition of employment. This would frustrate the intent of Congress concerning which

services performed in connection with American aircraft and vessels are to be included in employment for purposes of the FICA.

2)(c) Whether the remuneration received by the NRA flight attendants for services that are determined to be included in the definition of "employment" under section 3121(b) is "wages" under section 3121(a) subject to FICA tax whether or not the remuneration is gross income of the NRA flight attendants from sources within the United States?

Wages is broadly defined in section 3121(a) as all remuneration for employment, whether paid in cash or property, unless a specific exception applies. Thus, the remuneration received by the NRA flight attendants for their performance of services that are included in employment is wages for purposes of FICA, unless an exception applies. There is no exception from the definition of wages in the statute or regulations that applies in this case. In section 2)(a) above, relating to section 3121(b), we illustrated how the statute and regulations do not require determinations of the source of income under section 861(a)(3) for purposes of determining FICA tax liability. Thus, remuneration for employment is includible in wages under section 3121(a) for purposes of the FICA, regardless of whether the remuneration is from sources within the United States and is includible in the gross income of the NRA flight attendant or is from sources without the United States and is excludable from the gross income of the NRA flight attendant.

Rev. Rul. 78-216, 1978-1 C.B. 305, is analogous authority providing that remuneration of the NRA flight attendant is subject to FICA and FUTA taxation. Rev. Rul. 78-216 provides that services performed by NRA crew members on and in connection with an American vessel that stops at United States ports to refuel are included in employment for purposes of the FICA and FUTA, and the remuneration for such services is subject to FICA and FUTA taxes, even though all services of the crew are performed outside the United States and the remuneration is not wages for purposes of U.S. income tax withholding.

Despite the plain statutory language and analogous revenue ruling, Taxpayer makes several arguments as to why the remuneration for employment in this case is not wages subject to FICA tax. First, Taxpayer argues that the portion of the remuneration of the NRA flight attendants that is not included in gross income (either by application of the business visitor exception or because the amounts are apportioned to sources without the United States), cannot be wages for FICA tax purposes because generally FICA wages can only include amounts that are includible in gross income. Second, Taxpayer argues that the United States may not collect U.S. employment taxes from a U.S. taxpayer with respect to remuneration paid for services of an employee of the taxpayer working in a branch office of the taxpayer located in a foreign country if the labor laws of the foreign country prohibit the unilateral withholding of U.S. employment taxes from the NRA flight attendants. Third, Taxpayer argues that regardless of what the statute and

regulations provide the decision as to whether remuneration paid to the NRA flight attendants is subject to FICA taxes should take into account whether the NRA flight attendants can qualify for benefits under the U.S. social security system. Fourth, the Taxpayer maintains that it should not be liable for U.S. employment taxes because its obligation to withhold on the remuneration of the NRA flight attendants did not satisfy the concern expressed by the United States Supreme Court that the employer's obligation to withhold be "precise and not speculative." *See* Central Illinois Public Service Co. v. United States, 435 U.S. 21 (1978). Fifth, Taxpayer argues that it is not the employer under section 3401(d) for purposes of liability for U.S. income tax withholding and pursuant to case law, for purposes of the FICA and FUTA, because its foreign branch office is a separate employer in control of the payment of wages under section 3401(d)(1). Each of these arguments is analyzed below.

2)(c)(i) Amounts that are excluded from U.S. gross income can be included in FICA wages.

Taxpayer's first argument is essentially that amounts that are excluded from gross income can not be included in the section 3121(a) definition of wages for purposes of the FICA. Taxpayer cites a Fifth Circuit case, Dotson v. United States, 87 F.3d 682 (5th Cir. 1996) to support its position. In Dotson, the court concluded that amounts that were excluded from gross income under section 104(a)(2) as damages on account of personal injury were not wages for purposes of the FICA and FUTA. The court stated:

> The portion of the settlement determined to be excludable from taxable income on remand to the district court should also be excludable from wage taxes. Damages not included in the tax code's definition of "income" are not considered "wages." Rowan Companies, Inc. v. United States, 452 U.S. 247, 254 (1981). As such, they are not taxable under FICA. Redfield v. Insurance Co. of North America, 940 F.2d 542, 548 (9th Cir. 1991), Anderson v. United States, 929 F.2d 648, 654 (Fed. Cir. 1991). Neither are they taxable under FUTA, since FICA and FUTA use the same definition of wages. Code §§ 3121(a) and 3306(b).

Taxpayer also relies on language in the FICA statute. Section 3101, applying the employee portion of the FICA tax, states that there shall be imposed on the income of every individual a tax equal to a percentage of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)). Taxpayer argues that this language means that amounts received by an employee must first be income for U.S. income tax purposes before they can constitute wages for purposes of the FICA. In addition, the legislative history to the FICA tax refers to the tax under section 3101 as an income tax. See H.R. Rep. No. 74-615 at 29 (1935); S. Rep. No. 628 at 25 (1935).

The IRS does not agree with the principle that amounts must be includible in gross income and wages for U.S. income tax withholding purposes to be wages for FICA tax

purposes. First, there are very specific statutory and regulatory provisions, and legislative history indicating that these particular services are intended to be subject to FICA tax. There also is published guidance that concludes that analogous remuneration that is not subject to income tax withholding is subject to tax under the FICA and FUTA. Second, Taxpayer's reliance on Dotson and similar holdings is unpersuasive because of the factual and legal differences from the present case. Third, there is targeted Congressional legislation addressing the concept of the decoupling of FICA and FUTA wages from wages for purposes of U.S. income tax withholding.

The remuneration in dispute here is for services that are included in employment pursuant to very specific provisions of the Code that include the NRA flight attendants' services in employment. As discussed above in section 2)(a), section 3121(b) is targeted to services performed on an American aircraft or vessel for an American employer. Whatever more general principles may apply in determining wages for FICA purposes, the statute is quite specific about what constitutes wages where these facts are present. If the remuneration for employment for these services were not treated as subject to FICA taxes, it would frustrate Congressional intent to have these services included in employment regardless of the place where services are performed or the citizenship of the employee.

Historically, U.S. income taxation of NRAs has been based on sourcing of income. Part of the section 3121(b) definition of employment reflects sourcing rules similar to those applicable for purposes of income taxation. For example, employment generally includes services performed by NRAs "within the United States." However, the FICA definition of employment goes beyond sourcing for purposes of determining gross income and income tax to include certain services by NRAs that are performed outside the United States on or in connection with American aircraft. The statute and regulations specifically provide that these services are employment and section 31.3121(b)-3(c)(vi) provides that with respect to services performed outside the United States on or in connection with an American aircraft, the citizenship or residence of the employee is immaterial. To accept Taxpayer's position in this case would render the statute and this longstanding regulation virtually meaningless by, in effect, providing that FICA taxation would only apply to a NRA's services on or in connection with American aircraft if the services were performed within the United States.

Taxpayer's position also conflicts with the legislative history of these FICA provisions. When the portion of the definition of employment related to American vessels was added in 1939 (which was later expanded to include service on or in connection with American aircraft), Congress acknowledged that it was extending coverage to foreign seamen but recognized "[t]he number of foreign seamen who may be employed on American vessels engaged in trade is limited under our shipping laws." *See* H.R. Report No. 728, 76th Cong., 1st Sess.1, 46 In the Social Security Act Amendments of 1950, Congress again noted its intention to include in employment services performed on or in connection with an American aircraft regardless of the citizenship or residence

of the employee. *See* H.R. Rep. 1669, 81st Cong., 2d Sess.132 (1950) quoted in section 2)(a).

The application of the regulations was made clear in Rev. Rul. 78-216, 1978-1 C.B. 305, which provides that services on and in connection with an American vessel that stops at United States ports to refuel are included in employment for FICA tax purposes and the remuneration for such services is subject to FICA and FUTA taxes, even though all services of the crew are performed outside the United States and the remuneration is excepted from wages for purposes of U.S. income tax withholding pursuant to section 31.3401(a)(6)-1(b). (Section 31.3401(a)(6)-1 of the regulations provides that remuneration paid to a NRA individual (other than a resident of Puerto Rico) for services performed outside the United States is excepted from wages and is not subject to withholding. Such remuneration would generally be excluded from the U.S. gross income of the employee.)

Second, Taxpayer's reliance on Dotson is not persuasive as the instant factual situation is distinguishable from Dotson in several respects. The Dotson case concerned the issue of whether "damages" for personal injury excludable from income under section 104(a)(2) are wages for purposes of the FICA. Three other circuits, in addition to the Fifth Circuit, have expressed the view that if amounts are excluded from gross income, the amounts are not wages for FICA tax purposes: (a) the Ninth Circuit, Redfield v. Insurance Co. of North America, supra; (b) the Sixth Circuit, Gerbec v. United States, 164 F.3d 1015 (6th Cir. 1999); and (c) the Federal Circuit, Anderson v. United States, supra; and CSX Corp. v. United States, 518 F.3d 1328 (Fed. Cir. 2008).

After determining that the payments were excluded from gross income under section 104, the court in Dotson (as did the court in Gerbec and Redfield) provided minimal analysis, stating simply that because the payments are not included in gross income, the payments cannot constitute wages. The IRS agrees that to the extent the payments are made on account of personal injury, the payments would not constitute remuneration for employment. Therefore, the Dotson conclusion on that point is correct regardless of the effect of the exclusion from gross income. However, the employment tax status of payments on account of personal injury that are excludable under section 104(a)(2) is not in dispute in this case. Also, as noted, this case is different than Dotson because of the specific statutory language, regulations, legislative history, and revenue ruling that apply here.

Third, the IRS does not agree with the principle that amounts must be includible in gross income to be wages for FICA tax purposes. Specific Congressional legislation has addressed the decoupling of wages for FICA and FUTA purposes from wages for purposes of U.S. income tax withholding.

"Wages" is broadly defined for purposes of the FICA and FUTA under section 3121(a) and section 3306(b) as including all remuneration for employment, whether paid in cash

or property, unless a specific exception applies. Consistent with that broad definition of wages and taking into account the purposes of the FICA and the Social Security Act, prior to 1982, the IRS had a longstanding position that amounts could be included in FICA and FUTA wages even though they were excluded from gross income and not subject to income tax withholding. This position was reflected in regulations existing since 1940 providing that the value of meals and lodging furnished to restaurant or hotel employees or to seamen or other employees aboard vessels were wages for FICA and FUTA purposes regardless of whether the value of the meals and lodging were excluded from gross income under section 119 (or its predecessors).[10] For income tax withholding purposes, the regulations provided that the value of meals and lodging is excluded from wages if the value is excludable from gross income under section 119.

In Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981), the Supreme Court held regulations that included the value of meals and lodging in wages for FICA and FUTA purposes, but whose value was excludable from gross income under section 119, to be invalid. The Court found that the definition of wages for FICA and FUTA purposes must be given similar interpretations as the definition of wages for income tax withholding purposes.

In response to the Rowan decision, Congress enacted the Social Security Amendments of 1983 (the 1983 Amendments). The 1983 Amendments added flush language to section 3121(a) and 3306(b) that is generally referred to as the anti-Rowan amendment, and provides that "nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from "wages" as used in such chapter shall be construed to require a similar exclusion from "wages" in the regulations prescribed for purposes of this chapter." The result is that amounts may be wages for FICA and FUTA purposes, but not for income tax withholding purposes.[11]

The anti-Rowan amendment supports the conclusion that amounts that are not income may nevertheless constitute wages for purposes of the FICA and FUTA. This interpretation is supported by the legislative history to the 1983 Amendments which states:

> The social security program aims to replace the income of beneficiaries when that income is reduced on account of retirement and disability. Thus, the amount of "wages" is the measure used both to define income which should be replaced and to compute FICA tax liability. Since the [social] security system has

[10] This position was also reflected in Rev. Rul. 65-208, 1965-1 C.B. 383 (holding that salary reduction contributions to a section 403(b) annuity were subject to FICA taxes, although such contributions were excludable from gross income and not subject to income tax withholding.)

[11] Also as part of the 1983 Amendments, Congress enacted a number of different provisions that included in FICA wages certain amounts that were excluded from gross income and excluded from wages for income tax withholding purposes. *See* sections 3121(a)(5)(D), 3121(v)(1)(A), 3121(v)(1)(B), and 3121(v)(2).

> objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit tax exclusion.

S. Rep. No. 98-23 at 42 (1983).

Soon after the passage of the anti-Rowan amendment, three circuit courts upheld the position that amounts excludable from income can be subject to FICA taxes without a specific statutory provision in effect that included the amounts in FICA wages. *See* Temple University v. United States, 769 F.2d 126 (3d Cir. 1985), cert. denied, 476 U.S. 1182 (1986); New England Baptist Hospital v. United States, 807 F.2d 280 (1st Cir. 1986); and Canisius College v. United States, 799 F.2d 18 (2d Cir. 1986). These cases all considered the issue of whether contributions to section 403(b) plans were wages for FICA purposes for years before 1984, in situations where taxpayers paid the FICA tax on the contributions.

The Third Circuit held, in Temple University that "neither section 3121(a), even as it existed prior to the relevant [1983 and 1984] amendments, nor the Rowan decision entitles plaintiff to a refund of the FICA taxes paid" on the section 403(b) contributions. 769 F.2d at 135-36. Thus, the three cases essentially hold that amounts can be included in FICA wages based on the sole authority of the anti-Rowan provision contained in the penultimate sentence of section 3121(a) and a revenue ruling (Rev. Rul. 65-208).

A case concerning the FICA taxation of contributions made under pick-up plans through salary reduction agreement supports the concept that amounts can be included in remuneration for employment within the basic definition of wages under the FICA even though excluded from gross income. *See* Public Employees' Retirement Board v. Shalala, 153 F.3d 1160 (10th Cir. 1998).

The Fourth Circuit has also indicated disagreement with the notion that only amounts includible in gross income can be includible in FICA wages. In STA of Baltimore –ILA Container Royalty Fund v. United States, 621 F.Supp. 1567, 1573 (D.C. Md. 1985), aff'd 804 F.2d 296 (4th Cir. 1986), the district court stated that "[i]n enacting the Social Security Amendments of 1983, Congress decided to override the Rowan decision." The court quoted with approval the 1983 Amendment committee reports (concerning the effect of the anti-Rowan amendment), which state that "amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion." The court also stated that the 1983 Amendments "effectively overrode the Rowan decision." Id. at 1573. On appeal, the Fourth Circuit was "persuaded by the thorough and sound analysis of the district court" and affirmed "for the reasons expressed by the district court." 804 F.2d at 296.

Thus, the statute, regulations, and legislative history of the FICA, as well as case law (i.e., (1) First Circuit, New England Baptist Hospital; (2) Second Cir., Temple University; (3) Third Cir., Canisius College; (4) Fourth Cir., STA Container Royalty Fund; and (5) Tenth Cir., Public Employees Retirement Board) all support the position that the remuneration paid to the NRA flight attendants for services included in employment is subject to FICA taxes regardless of whether the remuneration is includible in gross income and subject to U.S. income tax withholding.

2)(c)(ii) FICA withholding liability should apply even if foreign law prohibits withholding.

Taxpayer's second argument is that foreign law prohibits the withholding of employee FICA tax. There is nothing in the Code that provides an exception from FICA taxation based on a foreign law that bars or creates adverse consequences for tax withholding.[12] In any event, this argument has no application to either the FICA employer tax or the FUTA tax, because these taxes are imposed solely on the employer and are not withheld from the employee.

The cases cited by Taxpayer in support of this argument have no application to this fact situation. As discussed in section 1)(d)(ii) above, the cases cited involve the issue of whether the IRS was permitted to reallocate income between entities under Code section 482 and impose income tax on amounts a party did not and never could receive. In the instant case, we are not concerned with the reallocation of income; we are looking to tax the payor of the wages on the amount that it did pay to each NRA flight attendant.

2)(c)(iii) The IRS should not take into account whether the NRA flight attendants will qualify for social security benefits in determining FICA taxation.

Taxpayer maintains that the IRS determination of FICA taxation in this case should take into account whether the NRA flight attendants will qualify for social security benefits. However, the Code imposes tax irrespective of whether the employee receiving the wages is expected ever to be eligible to receive benefits. The FICA statute enacted by Congress specifically included services performed on or in connection with an American aircraft on a flight that touches a port in the United States, regardless of the citizenship or residence of the employee. Thus, the issue of whether employees are likely or not to accumulate enough quarters of coverage to qualify for social security benefits is not taken into account in determining FICA tax.[13]

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[12] As discussed later, sections 3101(c) and 3111(c) provide relief from FICA taxes in cases covered by certain international agreements, such as totalization agreements. It is through the negotiation of a totalization agreement that differences, conflicts, and overlaps between a foreign country's social security laws and the United States social security laws are taken into account.

[13] Congress has recognized that NRA flight attendants or other crew members with D visas may become eligible to receive social security benefits. In the Social Security Protection Act of 2004 (P.L. 108-203)

2)(c)(iv) The Central Illinois "Deputy Tax Collector Defense" does not apply.

Taxpayer's fourth argument is that its obligation to withhold the employee portion of FICA taxes was not sufficiently clear, and therefore, it cannot be held liable for the payment of the tax. As discussed in the context of section 1)(d)(iii) above, the argument arises from Central Illinois, supra, 435 U.S. at 29-33, and is also known as the "deputy tax collector defense."

As with regard to U.S. income tax withholding, the Central Illinois argument arises from the "secondary position as to liability" of the employer with respect to the employee portion of the FICA. See Central Illinois, 435 U.S. at 31. The argument is not applicable to either the employer portion of FICA taxes or FUTA taxes as these taxes are imposed solely on the employer and therefore, the employer is not acting as "deputy tax collector" for the Government with respect to those taxes. See North Dakota State Univ., 255 F.3d at 608 (the "defense applies only to that portion of the FICA tax required to be withheld from the employee; it does not apply to the employer's obligation to pay its portion of the FICA tax.")

The argument is unpersuasive with regard to the employee portion of FICA as Taxpayer had ample notice of its obligation to withhold and pay employment taxes for services performed by the NRA flight attendants. The statute and regulations are clear that the NRA flight attendants' services are included in employment for FICA. Further, Rev. Rul. 78-216 holds that remuneration for similar services performed on or in connection with an American vessel is wages for FICA and FUTA purposes. The conclusion in Rev. Rul. 78-216 was reached even though the NRA employees performed no services within the United States. The fact that there may have been a settlement of related issues at Appeals in an audit for prior years does not have the effect of replacing the statute, regulations and revenue ruling with a new legal framework conforming to the Appeals opinion. There are a number of factors that may go into an Appeals decision, including hazards of litigation that are separate from the merits of the legal arguments. Therefore, we conclude that Central Illinois does not apply to prohibit imposition of any employee FICA tax at issue in the instant case, and in no event, can it ever preclude Taxpayer's liability for the employer FICA tax or the FUTA tax.

2)(c)(v) Branches of Taxpayer are not employers under section 3401(d)(1).

Congress placed restrictions on the receipt of SSA benefits by NRAs who are not authorized to work in the United States. NRAs admitted to the United States under a B-1 (for business purposes) or D (for crewman) visa are excepted from these restrictions. Taxpayer's NRA flight attendants typically are admitted to the United States with a D visa and thus, are recognized by Congress as entitled to receive benefits if the requirements to receive benefits are satisfied.

This issue is discussed in connection with section 1)(d)(iv) above and the analysis there applies equally for purposes of FICA and FUTA. The Taxpayer is the employer under section 3401(d) and the employer for purposes of FICA and FUTA.

2)(d) Additional FICA Analysis.

2)(d)(i) FICA taxation of NRA flight attendants who are residents of Country X and who are based in Country X.

The services of the NRA flight attendants who are residents of Country X and who are based in Country X are not subject to FICA taxes as a result of the totalization agreement between the United States and Country X. The totalization agreement generally provides that traveling employees of air transportation companies who perform work in the territories of both Contracting States and who would otherwise be covered under the laws of both Contracting States shall, with respect to that work, be subject to the laws of only the Contracting State in the territory of which the firm has the home office (i.e., the United States in this case). However, the totalization agreement further provides an exception to the effect that if such employees reside in the territory of the other Contracting State (Country X in this case), they shall be subject to the laws of only that State (Country X in this case).

Sections 3101(c), relating to the employee portion of FICA, and 3111(c), relating to the employer portion of FICA, provide that during any period in which there is in effect a totalization agreement, wages received by or paid to an individual shall be exempt from the taxes imposed by sections 3101 and 3111 to the extent that such wages are subject under such agreement exclusively to the laws applicable to the social security system of such foreign country. Under the totalization agreement, a certificate of coverage issued by one country serves as proof of exemption from social security taxes on the same earnings in the other country.

Thus, the effect of the above provision is that the remuneration for services of a NRA flight attendant who is a resident of Country X working out of the Country X branch office is not subject to FICA taxes provided a certificate of coverage issued by Country X is obtained for the individual for services otherwise included in FICA employment. However, the entire amount of the remuneration for services of a NRA flight attendant who is a resident of a country other than Country X (if any) and who works out of the Country X branch office is subject to FICA taxes pursuant to the general rule in the totalization agreement.

(3) FUTA

3)(a) Whether services performed by the NRA flight attendants are employment for FUTA tax purposes?

Section 3306(c), the definition of employment for purposes of the FUTA, contains similar language as section 3121(b), the definition of employment for purposes of the FICA, with respect to services performed on or in connection with an American aircraft. In addition, the applicable FUTA regulations under section 31.3306(c)-2 concerning the definition of employment are similar to the FICA regulations. Thus, a similar conclusion as FICA should apply for FUTA purposes. Because the NRA flight attendants are performing services on American aircraft and are performing such services on or in connection with the aircraft when outside the United States, the services on or in connection with flights that touch a port in the United States are included in the definition of employment for purposes of the FUTA.

3)(b) Whether the included-excluded rule provided by section 3306(d) applies if only a portion of the NRA flight attendant's are included in the basic definition of employment in the flush language at the beginning of section 3306(c)? Does Rev. Rul. 79-318 apply for purposes of the FUTA?

The statutory structure of the FUTA included-excluded rule in section 3306(d) is similar to the FICA rule in section 3121(c). Therefore, the conclusion reached with respect to the FICA should also apply with respect to the FUTA, and Rev. Rul. 79-318 does apply for purposes of the FUTA. Accordingly, we conclude that only remuneration for services that are included in employment for purposes of the FUTA is counted in applying the included-excluded rule.

3)(c) Whether the remuneration received by the NRA flight attendants for services that are determined to be included in the definition of "employment" under section 3306(c) is "wages" under section 3306(b) subject to FUTA tax whether or not the remuneration is gross income of the NRA flight attendants from sources within the United States?

The statutory and regulatory provisions relating to "wages" and "employment" for purposes of the FUTA are similar to the FICA provisions. *See* sections 3306(b) and (c). Therefore, the FUTA result is the same as the FICA result. FUTA tax applies to remuneration received for employment regardless of whether the remuneration is excludable from the gross income of the NRA flight attendant.

However, several arguments raised by Taxpayer with respect to the FICA have no application with respect to the FUTA because the FUTA tax is imposed solely on the employer. Taxpayer's arguments with respect to Central Illinois (the "Deputy Tax Collector Defense") cannot apply because the FUTA tax is not a tax for which the Taxpayer is secondarily liable. *See* North Dakota State Univ., 255 F.3d at 608, which states that the "[Deputy Tax Collector] defense applies only to that portion of the FICA tax required to be withheld from the employee; it does not apply to the employer's obligation to pay its portion of the FICA tax." Similarly, Taxpayer's argument that foreign law prohibits U.S. tax withholding is irrelevant for FUTA tax purposes.

Also, as with the relationship of FICA taxation and social security benefits, FUTA taxation is not based on whether the NRA flight attendants may become entitled to the receipt of state unemployment benefits. Rev. Rul. 75-87, 1975-1 C.B. 325, holds that an employer is liable for FUTA taxes with respect to wages paid to its employees regardless of whether it is exempt from the state unemployment compensation tax or its employees are ineligible for unemployment compensation benefits.

The exception related to totalization agreements applicable under the FICA to NRA flight attendants who are residents of Country X is inapplicable to the FUTA. Totalization agreements affect FICA liability, but not FUTA liability. Thus, Taxpayer is liable for FUTA taxes with respect to the NRA flight attendants who are residents of Country X working from the Country X base under the same standard as employees working from the bases in the other Foreign Countries.

Thus, the IRS position is that FUTA taxes apply to the remuneration for employment paid by Taxpayer to the NRA flight attendants regardless of whether the remuneration is includible in the gross income of the NRA flight attendant.

(4) Section 530 of the Revenue Act of 1978

There is a question whether Taxpayer is entitled to relief under section 530 of the Revenue Act of 1978 from any U.S. employment tax liability with respect to the remuneration paid to the NRA flight attendants.

Section 530(a)(1) of the Revenue Act of 1978, as amended, provides:

> (1) IN GENERAL.--If-
>
> (A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
>
> (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,
>
> then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

Taxpayer asserts that its exclusion of the entire compensation paid to the NRA flight attendants from employment taxes and its resulting exclusion of the compensation from its employment tax returns and from any Forms W-2 means that it did not treat the NRA flight attendants as employees for U.S. employment tax purposes, and, therefore, met the criterion of section 530(a)(1)(A). Taxpayer excluded the compensation from employment taxes based on its reliance on exceptions from the term "wages" in the FICA, FUTA, and income tax withholding provisions and on the discussion of the definition of "wages" in Dotson.

The legislative history of section 530 is abundantly clear that the focus of section 530 relief was worker classification disputes and that alone.[14] The Joint Committee on Taxation explained in the General Explanation of the Revenue Act of 1978 at page 301 that, "The Act provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the Internal Revenue Service as a result of the IRS' proposed reclassification of workers, whom taxpayers have considered as having independent contractor status…" In Sen. Rept. 95-1263, 95th Cong. 2d Sess. 210, the Committee on Finance reports:

> The committee believes it is appropriate to provide interim relief for Taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments as a result of the Service's proposed reclassification of workers, until the Congress has adequate time to resolve the many complex issues involved in this area…the bill prevents the Internal Revenue Service from reclassifying certain individuals as employees for purposes of Federal income tax withholding, Social Security taxes and unemployment taxes. Individuals (or classes of individuals) who may not be reclassified are those whom the taxpayer consistently has treated in good faith as independent contractors for employment tax purposes. The taxpayer shall be deemed to have acted in good faith only if all Federal tax returns (including information returns) required to be filed by the taxpayer were filed on a basis consistent with the taxpayer's treatment of such individuals as independent contractors and the taxpayer treated such individuals as independent contractors in reasonable reliance under one or more of four tests.

Accordingly, a taxpayer may be entitled to section 530 relief in circumstances where the IRS is considering whether to reclassify workers from independent contractor status (or

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[14] When statutory language is not clear, legislative history is instructive. See Hightower v. Texas Hospital Association, 65 F.3d 443, 448 (5th Cir. 1995) ("When courts interpret statutes, the initial inquiry is the language of the statute itself. We look at the language of the statute as well as the design, object and policy in determining the plain meaning of a statute. The statute must be read as a whole in order to ascertain the meaning of the language in context of the desired goals envisioned by Congress. Only if the language is unclear do we turn to the legislative history." (Citations omitted throughout quote.))

other nonemployee status such as partner) to employee status. By contrast, section 530 is not relevant to the examination if the question is whether compensation paid to an employee is excluded from wages or whether services performed by individuals who are otherwise employees are excluded from employment.

In addition to legislative history, case law supports this interpretation. In United States v. McLaughlin, 663 F.2d 949, 952 (9th Cir. 1981), the Ninth Circuit stated, "In enacting [section] 530, Congress clearly looked to the taxpayer's treatment of the individual, not to particular payments to an individual. The legislative history of the section confirms this." While the case involved workers who were treated as employees and received second checks that were not treated as wages, facts which are different from those presented here, the case supports the view that section 530 is limited to the question of classification of individuals, not payments.

Consistent with this view, in Flamingo Fishing Corp. v. United States, 32 Fed.Cl. 377 (1994), the Court of Federal Claims analyzed whether the taxpayer treated individuals as not employees for purposes of Code section 3509 in a manner similar to the way the Ninth Circuit Court of Appeals addressed the issue in the context of section 530 in the McLaughlin case. In Flamingo Fishing Corp., taxpayers argued that the benefits of lower tax liability under section 3509 applied in that they failed to deduct and withhold employment taxes on the basis that a narrow exception to the definition of "employment" under section 3121(b)(20) exempted the payments to their crew members from such tax. As a result, plaintiffs contended these crew members were treated as "self-employed" or non-employees, and thereby subject to the lower tax liability provided under section 3509.[15] The court stated that section 3509 applies only when an employer fails to deduct and withhold by reason of treating an employee as a non-employee, not when the services of such employee were defined as non-employment under section 3121(b). For further support, the court stated that the legislative history indicates that section 3509 was enacted to provide relief in situations wherein the IRS later classified non-employees, such as independent contractors, as employees.[16]

[15] Code section 3509 provides reduced rates for the employee share of FICA tax and income tax withholding in cases in cases where the employer "failed to deduct and withhold [such taxes] with respect to any employee by reason of treating such employee as not being an employee."

[16] "The committee is aware that the employment status controversies that led to enactment of the interim relief provisions of the Revenue Act of 1978 were aggravated by the serious retroactive tax burdens that may arise when a worker who has been treated as an independent contractor is reclassified as an employee.... Accordingly, the committee bill provides a statutory offset mechanism that will apply in reclassification cases. This provision represents a substantial simplification of present law procedures and will reduce burdens on employers whose workers were reclassified." S.Rep. No. 494, 97th Cong., 2d Sess., at 370 (1982).

In this case Taxpayer has consistently treated the NRA flight attendants working in the Foreign Countries as employees for all apparent purposes[17] and the IRS is not attempting to reclassify them from independent contractor or other nonemployee to employee status. Nor is Taxpayer asserting they are anything other than employees. Rather, Taxpayer is relying on exceptions from the term "wages" under the relevant employment tax provisions that are applicable only to employees and the discussion of the definition of "wages" in Dotson, and the IRS is contesting Taxpayer's application of such exceptions from the term "wages."

Taxpayer did not withhold U.S. income tax or FICA tax from the NRA flight attendants' compensation, issue a Form W-2 to the NRA flight attendants, or include their compensation on its U.S. employment tax returns, all on the basis that the compensation was purportedly excluded from the term "wages" for employment tax purposes. Taxpayer did not file any Forms 1099 to report the compensation, on the basis that no reporting was required if Taxpayer's reliance on the exceptions from "wages" was accurate. While Taxpayer has not affirmatively demonstrated its treatment of the NRA flight attendants as employees for employment tax purposes, Taxpayer has not in any way affirmatively treated the individuals as nonemployees. The lack of any affirmative showing of employee treatment is only a natural consequence of Taxpayer's application of the "wages" exceptions, not because of any belief or assertion that the NRA flight attendants did not otherwise satisfy the test for employee status under the employment tax provisions. The failure to pay U.S. employment taxes and to fulfill the corresponding employment tax obligations is based on Taxpayer's interpretation of the exceptions from "wages." The classification of the NRA flight attendants — the focus of both the language and intent of section 530 — is not at issue in this case. Accordingly, entitlement to relief under section 530 is not properly at issue in this case.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

[17] In fact, the email response from Taxpayer on the application of section 530, dated May 12, 2009, states, "The fact that [Taxpayer] treated the workers as employees does not block Section 530 from applying." (Emphasis added.)