U.S. Income Tax Planning for a Nonresident's Personal Service Income

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Introduction

Practitioners advising entities transacting business in the United States must also consider the tax implications of the individual sent to act as its representative in the United States. This applies to the manufacturing company which is sending an individual to the United States to organize a distribution system of representatives, an engineering firm that is providing engineering design and service to a U.S. company, an entity which sends a representative to negotiate and work out terms to acquire a U.S. company, as well as the representative in the United States selling on a commission basis. This article will discuss the U.S. tax system as it applies to nonresident alien individuals, focusing particularly on personal service income. It will deal generally with the overall tax problems of the nonresident alien and will suggest planning techniques which can be utilized. The main focus will be on the nonresident alien who is performing services on behalf of another entity. There has been no attempt to deal with specialized problems such as certain residents of Puerto Rico or diplomats. In addition to dealing with the U.S. tax laws as set out in the Internal Revenue Code, major reference is also made to the French-U.S. and the Swiss-U.S. Income Tax Conventions.

Generally, a resident alien is taxed in the same manner as a U.S. citizen. A nonresident alien, on the other hand, will only be taxed under the Internal Revenue Code (Code) on income which has a U.S. source and in which there is no trade or business, and income from a U.S. trade or business.[1] This, however, is subject to modification by a treaty. The tax analysis and planning for a nonresident alien will depend on several factors including:

1. The residence of the alien;
2. The source of the income;
3. The place the service is performed;
4. If the income is related or "effectively connected" with a U.S. trade or business;
5. The taxable year in which the income is received;
6. The employment relationship with a nonresident entity;

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[1]26 U.S.C. § 872(a)(1) and (2).

7. Availability of a tax treaty;
8. Special provisions of the treaty; and
9. The possibility of modifying the facts to obtain a more favorable result.

Resident or Nonresident Alien?

The first question to determine is whether the alien is a resident alien (RA) or a nonresident alien (NRA) of the United States. There is no definition of a NRA or a RA in the Code. The regulations, cases, and rulings do, however, provide a reasonable amount of guidance.

An investor or executive coming to the United States to perform services will obtain a visa. It may be an immigrant or nonimmigrant visa. An individual admitted to the United States on an immigrant visa is admitted for permanent residence. There are no restrictions on the kind or amount of work which an immigrant may do while in the United States. Every alien present in the United States is presumed to be an "immigrant" unless he has entered on a nonimmigrant visa.[2] A nonimmigrant is an alien admitted for a special purpose and a specific period of time. He may be restricted from working or if allowed to work, will be limited in what he can do. The typical nonimmigrant visas for executives and investors will be the treaty trader (E-1), treaty investor (E-2), and intracompany transfer (L-1). The investor or executive admitted on an L or an E visa will be admitted for a period of one year with a right of renewal for one year at a time.[3]

The classification for immigration purposes will not be determinative for tax purposes. Presence in the United States will not cause an alien to be a resident. The regulations define a resident as one present in the United States "who is not a mere transient or sojourner."[4] Generally, however, an individual who comes to the United States on an immigrant visa will be taxed as a resident alien. This is the general rule because in his visa application he expresses an intent to make this his home. Where his intention is not to make his home in the United States, he will not be taxed as a resident alien.[5]

For our analysis, the focus will primarily be concerned with an individual who has a nonimmigrant visa. The executive who comes to the United States, lives in temporary quarters, and departs the United States within three or four months will not be regarded as a resident for tax purposes. His intention upon arrival may, however, be subject to change. If an individual comes for the purpose of only making investments but is prevented from leaving the United States due to circumstances beyond his control, the fact that he stays here and makes the United States his home may result in

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[2]8 U.S.C. § 1184(b).
[3]8 C.F.R. § 214.2(e) and (d) (1982).
[4]Treas. Reg. § 1.871-2(b) (1957).
[5]William Adams, 46 T.C. 352 (1966).

his being taxed as a resident alien.[6] For purposes of guidance, the Internal Revenue Service (IRS) has taken the position that an alien present in the United States for a full taxable year is presumed to be a resident.[7] With respect to an E visa alien, the IRS has issued a ruling which states that an E visa alien will be taxed as a resident where it can be shown that the alien is here for a full year and is not a mere transient.[8] Given the circumstances of a nonimmigrant coming to the United States for the purpose of performing temporary services, being in the United States for less than a year, not purchasing a home or bringing his family and not establishing social contacts in the United States, the individual probably will be treated as a nonresident alien. As a general rule, the regulations provide an assumption of nonresidence to nonimmigrants "in the absence of exceptional circumstances."[9]

Source Rules for Compensation

As stated initially, a NRA can be subject to U.S. tax if he receives income which has its source in the United States. As an example, assume that before a nonimmigrant E visa holder comes to the United States he contracts with an employer in his native country (assume there is no income tax treaty with the United States) to perform services in the United States. He performs the services while in the United States, returns to his native home and is paid upon his return. The "source" of his compensation will be the United States. Source is determined on the basis of where the services are performed irrespective of where the contract is signed or payment is made.[10] With this in mind, the E visa alien may affect the potential tax results. If he has business planning to do which can be done prior to his arriving in the United States, he should do so. Even though the planning relates to services to be performed in the United States, it will not be determinative if, in fact, the services are not performed in the United States. The test is where the services are performed. If the alien is going to be paid a fee for work done in both the United States and Canada, his compensation will be apportioned between the two countries on the basis that most correctly reflects the proper source.[11] Frequently, the income will be apportioned simply on the basis of time spent in each country.[12] If, however, the taxpayer finds this inequitable, he should plan to document an alternative method of proof.

The definition of personal service income is not limited to services per-

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[6]Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950).
[7]Rev. Rul. 69-611, 1969-2 C.B. 150.
[8]Rev. Rul. 64-285, 1964-2 C.B. 184.
[9]Treas. Reg. § 1.871-2(b) (1957).
[10]Treas. Reg. § 1.861-4(a)(1), T.D. 7378, 1975-2 C.B. 272.
[11]Treas. Reg. § 1.861-4(b)(1), T.D. 7378, 1975-2 C.B. 272.
[12]James D. Mooney, 9 T.C. 713 (1947).

sonally performed.[13] A natural person can perform personal services through an agent[14] as well as an independent contractor.[15] In addition, a corporation can perform personal services.[16] A corporation which has an employee performing services in the United States will have personal service income to the extent the corporation is, in fact, selling a service. In addition, the compensation paid to the employee will also be personal service income to him. The exemptions for such income provided under the Code and treaties, however, will affect the ultimate taxation by each entity. The rules for personal service income apply to all forms of compensation[17] including deferred compensation.[18] Thus, the timing of the receipt of the income will not affect its character. If, however, an individual negotiates a settlement to a personal service contract and receives a specified amount which covers an agreement not to compete, this amount will not be treated as compensation.[19]

The Code provides an exception to the source rule for certain compensation. This is commonly referred to as the "commercial traveler" exemption. Under this exemption, compensation which would otherwise be U.S. source income will not be treated as U.S. source if:

> A. The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year,
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> B. Such compensation does not exceed $3,000 in the aggregate, and
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> C. The compensation is for labor or services performed as an employee of or under a contract with
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> (i) a non-resident alien, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or
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> (ii) an individual who is a citizen or a resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.[20]

The $3,000 dollar amount makes this exception of limited value. It is, however, interesting to analyze this exemption and to contrast it to the exemptions granted under treaties. In addition, to the ninety days and $3,000, it should be noted that the services must be performed as "an employee" or "under contract." This would exclude an individual performing services for his own account such as an athlete or entertainer. In addition, the exemption would not apply to a corporation which received

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[13]Helvering v. Boekman, 107 F.2d 388 (2d Cir. 1939).

[14]*Id.* Irene Vavasour Elder Perkins 40 T.C. 330 (1963).

[15]Rev. Rul. 73-107, 1973-1 C.B. 377.

[16]Rev. Rul. 60-55, 1960-1 C.B. 270.

[17]Rev. Rul. 70-543, 1970-2 C.B. 1972; Rev. Rul. 60-55, 1960-1 C.B. 270.

[18]Muhleman v. Hoey 124 F.2d 414 (2d Cir. 1942); Rev. Rul. 72-279, 1972-1 C.B. 218; Rev. Rul. 56-325, 1956-1 C.B. 371; Julian C. Stanford 34 T.C. 1150, 1159 (1960), *aff'd*, 297 F.2d 298 (9th Cir. 1961); James D. Mooney 9 T.C. 713 (1947) A., 1948-1 C.B. 2.

[19]Rev. Rul. 74-108, 1974-1 C.B. 248.

[20]26 U.S.C. § 861(a)(3) (1976).

revenue from personal services. The exemption applies only to services performed by an individual.

If the compensation exceeds $3,000, the entire amount will be U.S. source income.[21] The $3,000 amount is not deductible from the total. If, on the other hand, the NRA employee received $3,000 plus $2,000 of reimbursements for documented business expenses, the $2,000 could be excluded for purposes of the exclusion and the NRA would come within the $3,000 limitation.[22] The $2,000 should, however, be structured as a reimbursement for expenses. A salesman on commission who earns $5,000 and incurs $2,000 of expenses but has no reimbursement procedure could apparently not exclude the $2,000 and thus, would not come within the exemption. Assume the NRA earned $5,000 during 1979 but is paid $3,000 in December of 1979 and $2,000 in January of 1980. The regulations at section 1.861–4(a)(ii) state that the exclusion applies where the "compensation for such labor or services does not exceed . . . the gross amount of $3,000. . . ."[23] In our example, the compensation for such services was $5,000. As a result, the entire $5,000 would be taxable. It would not come within the commercial traveler exclusion. Assume the NRA spent fifty days in the United States, fifty days in Canada and fifty days in Mexico. If he were paid $9,000 for all his services, absent a more accurate method of allocation, he would allocate one-third of his income to the United States and would come within the exclusion.[24] If, however, the NRA received $3,000 for his services in the United States and also received $2,000 from a pension he earned for previous services in the United States, he could still come within the exclusion because the $2,000 of pension would not be used in measuring the $3,000 limitation.[25] This is a special rule for pensions and would not apply to a mere deferral. How long must it be deferred to be a pension? There is no definition of a "pension."

Treaty Exemptions

Treaties provide a tax exemption for compensation earned in the United States by a NRA working in the United States. The exclusion provided by a treaty is much more liberal than that provided in the Code. It typically provides that the alien not be present in the United States for more than 183 days in the taxable year. Compensation which is exempted in this manner is excluded from gross income.[26] Older treaties deal generally with personal service income. Newer treaties deal separately with "independent" personal service and "dependent" personal service. Some also provide separately for artists and athletes. For purposes of comparison, we will look at

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[21] Rev. Rul. 69-479, 1969-2 C.B. 149.
[22] Treas. Reg. § 1.861–4(a)(4), T.D. 7378, 1975-2 C.B. 272.
[23] Treas. Reg. § 1.864–2(b)(3) Ex. 2, T.D. 7378, 1975-2 C.B. 272.
[24] Treas. Reg. § 1.861–4(b)(1)(i), T.D. 7378, 1975-2 C.B. 272.
[25] Treas. Reg. § 1.861–4(a)(4).
[26] 26 U.S.C. § 894(a) (1976).

the exclusion provided by the U.S.-Swiss Income Tax Treaty and the U.S.-French Income Tax Treaty.

Under the Swiss treaty, an individual resident of Switzerland is exempt from U.S. tax on compensation for personal services performed in the United States if he is temporarily present in the United States for a period not exceeding a 183 days during the taxable year and either of the following conditions are met:

> A. Compensation is received for labor or personal services performed as an employee of, or under contract with, a resident or corporation or other entity of Switzerland, or
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> B. His compensation for such labor or personal services does not exceed $10,000.[27]

An individual attempting to utilize the treaty must, in fact, be a resident of Switzerland. Before his championship fight with Floyd Patterson, Ingemar Johansson attempted to qualify as a Swiss resident to come within the treaty (commercial traveler) exemption. It was determined, however, that because his trips to Switzerland were sporadic and of a short duration, he was not a Swiss resident under the treaty.[28] This determination was made by U.S. courts in applying U.S. law.

There is a noted distinction in the treaty between working for a Swiss entity and a non-Swiss entity. Compensation paid by a Swiss entity has no limitation, whereas the payment by a non-Swiss entity may not exceed $10,000. The Swiss organization, of course, must be more than a "front" for a non-Swiss organization. If it maintains a Swiss address with no substance and solely for purposes of availing the benefits of a treaty, the benefits will be denied.[29] However, where an entity maintains both Swiss and non-Swiss offices, the unlimited earning exemption should apply where the employment relationship is with the Swiss office. By transferring the alien to the employment of the Swiss organization, he should qualify. The unlimited earnings exemption would appear not to apply to independent activities. However, article X of the treaty (which specifically excludes the exemption for artists, athletes, etc.) was rejected when the convention was modified by the U.S. Senate. The treaty specifically includes as personal services, those services performed as a director and the practice of a "liberal profession."

The French treaty contains a similar "183 day" exception. This treaty, however, provides a specific provision for independent[30] as well as dependent[31] personal services. Independent activities include those, other than commercial or agricultural activities, carried on by an individual for his

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[27]U.S.-Swiss Income Tax Convention, Article X(1) (1951).

[28]Johansson v. U.S. 336 F.2d 809 (5th Cir. 1964), *aff'd on other grounds*, 374 F.2d 890 (5th Cir. 1967).

[29]Swiss Federal Government Decree, December 14, 1963.

[30]U.S.-French Income Tax Convention, Article 14 (1967).

[31]U.S.-French Income Tax Convention, Article 15 (1967).

own account where that person receives the proceeds or bears the losses arising from the activity.[32] This allows the exemption to apply to entertainers and athletes. The exclusion applies to a resident of France who performs "independent activities" in the United States if the individual is not in the United States more than 183 days in the taxable period, and does not maintain a "fixed base" in the United States for a period exceeding 183 days in such year.[33] It does not provide a maximum earning. The concept of "fixed base" is not defined in the convention but has been ruled to be similar to a "permanent establishment."[34]

The dependent personal service provision applies generally to employees. The exclusion applies to a resident of France who receives compensation with respect to employment performed in the United States where:

A. The recipient is present in the U.S. for a period not exceeding 183 days in the taxable year;

B. The remuneration is paid by, or on behalf of, an employer who is not a resident of the U.S.; and,

C. The remuneration is not borne by a permanent establishment which the employer has in the U.S.[35]

The last requirement noted above is not commonly found in a treaty. It is designed to prevent the transfer of the economic burden for the compensation by means of an intracompany charge to an establishment in the United States. It would apply if the French entity had an office in the United States to which an accounting charge was made for the employee's compensation. Because the provision refers to a "permanent establishment *which the employer has*" (emphasis added) in the United States, it is less clear whether an intracompany charge to a U.S. subsidiary would have the same effect. It seems that the intent would be to disqualify such compensation.

Also, in comparing the Swiss and French treaties, it should be noted that there is no maximum amount that can be earned by a resident of France while working for a non-French entity in the United States. A Swiss resident working for a non-Swiss entity, on the other hand, is limited to $10,000. Such distinctions in various treaties must be analyzed very closely to provide for proper planning.

In addition to the "commercial traveler" exemption noted above, most treaties will provide other exemptions, most notably for students and trainees. Generally, the exemption will apply to remittances received from abroad for study and maintenance. In certain circumstances, a limited amount of compensation received by students, trainees, and apprentices may be exempt from tax. The Swiss treaty provides an exclusion for a "student or apprentice" who comes to the United States exclusively for acquir-

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[32]U.S.–French Income Tax Convention, *supra* note 30, Article 14(3).
[33]U.S.–French Income Tax Convention, *supra* note 30, Article 14(2).
[34]Rev. Rul. 75-131, 1975-1 C.B. 389.
[35]U.S.–French Income Tax Convention, *supra* note 30, Article 15(2).

ing business or technical experience.[36] The IRS, however, has taken the position that this does not apply to an executive who is in the United States to study a particular industry for his employer.[37]

The French treaty differs from the Swiss treaty in several respects. It provides an exemption for a resident of France who is present in the United States as an employee or under contract for a French entity for the primary purpose of acquiring technical, professional, or business experience. The training cannot come from the French entity or one controlled (50 percent) by the French entity. This exemption is limited to one year and $5,000.[38] The French treaty would, therefore, be of some value with respect to providing training for business or professional experience. The Swiss treaty, on the other hand, would appear to apply only to students.

Various other treaty provisions provide a form of exclusion for pensions and annuities. The Swiss treaty[39] and the French treaty[40] both limit the ability to tax "pensions and annuities" to the country of residence of the recipient. This exemption will be discussed in greater detail later in this article.

Classification of Income

Once the source of the income has been identified, the next step is to classify the income. Is the income "fixed or determinable, annual or periodical" income which is taxed under section 871(a)(1) of the Code or is it "effectively connected with the conduct of a trade or business" and taxed under section 871(a)(2). Under section 871(a)(1), a NRA is subject to tax of 30 percent on all U.S. source income which is characterized as "fixed or determinable, annual or periodical." Specifically included under this section are salaries, wages, annuities, compensation, remunerations and emoluments. It does not include income which is "effectively connected" with the conduct of a trade or business. If there is a trade or business, the income will not be taxed as "fixed or determinable" but will be taxed under section 871(a)(2). Generally, any compensation will qualify as fixed or determinable to the extent it does not come within a trade or business or is not exempt under a treaty.

Under section 871(a)(2), a NRA is subject to tax at graduated rates on income which is "effectively connected" with a trade or business. Section 864(b) provides that the performance of personal services within the United States during a given taxable year constitutes the conduct of a trade or business within the United States during that year. As such, any compensation which is earned and paid in the same year will automatically be "effectively connected" income and will not be taxed as "fixed or determinable"

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[36]U.S.-Swiss Income Tax Convention, *supra* note 27, Article XIII.
[37]Rev. Rul. 62-203, 1962-2 C.B. 389.
[38]U.S.-French Income Tax Convention, *supra* note 30, Article 18(2).
[39]U.S.-Swiss Income Tax Convention, *supra* note 27, Article XI(2), (3) and (4).
[40]U.S.-French Income Tax Convention, *supra* note 30, Article 19.

income. The Code provides an exemption to the definition of a trade or business which is substantially similar to the ninety-day rule for the commercial travel "source" exemption.[41] The performance of personal services will constitute engaging in a "trade or business" whether the NRA performs for his own account, or as an employee of some other person or entity.[42] Thus, the employer as well as the employee is engaging in a trade or business. A separate determination of "engaged in a trade or business" will be made for each taxable year.[43]

A question under section 871 (a)(2) is when the income will be "effectively connected" with a trade or business. Generally, compensation received by a cash basis nonresident alien from a U.S. source will be considered "effectively connected" with a trade or business only if the alien performs services in the United States during the taxable year in which the income is received. If no trade or business is conducted within the United States during the year the income is received, the income will not be "effectively connected."[44] It will be "annual or periodical" income. Thus, if a NRA cash basis taxpayer performs personal services in year one and is paid in year two and no personal services are rendered in year two, the income received in year two will not be "effectively connected."[45] If, however, the alien is engaged in a different trade or business, including the performance of personal services for a different employer in year two, the compensation received in year two will be "effectively connected."[46]

As noted, the performance of personal services will constitute a trade or business which may have an effect on the employer of the individual performing the services in the United States. For purposes of planning for both the employer and the employee, it is important to understand the treaty exemptions. Under most treaties, an enterprise of one contracting state will be exempted from tax on its "industrial and commercial profits" earned in the other contracting state unless the earnings are attributable to a "permanent establishment" which it maintains there. The activity required will generally be more than the mere performance of personal services. Under a treaty, a foreign entity may be exempt from U.S. tax on the income which it derives from furnishing personal services, so long as it does not maintain a "permanent establishment" in the United States.[47]

Under the Swiss treaty, industrial or commercial profits "includes manufacturing, mercantile, mining, financial and insurance profits but does not include income in the form of . . . remunerations for personal services."[48]

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[41]26 U.S.C. § 864(b)(1) (1976); Treas. Reg. § 1.864-2(b), T.D. 7378, 1975-2 C.B. 272.
[42]Rev. Rul. 74-330, 1974-2 C.B. 278.
[43]26 U.S.C. § 864(c)(1) (1976); Treas. Reg. § 1.864-3(a) (1971).
[44]26 U.S.C. § 864(c)(1)(B) (1976).
[45]Treas. Reg. § 1.864-4(b) Ex. 3 (1972).
[46]Treas. Reg. § 1.864-4(c)(6)(ii) (1972); *cf.* Van Der Elst v. Commissioner 223 F.2d 771, 772 (2d Cir. 1955).
[47]Rev. Rul. 76-321, 1967-2 C.B. 470.
[48]U.S.-Swiss Income Tax Convention, *supra* note 27, Article II(i), (h).

This would not exempt income received by the employer for the rendering of personal services by an employee. The employer, however, would have a deduction of wages paid to the employee. The employee would look to the "commercial traveler" exemption. In addition, the definition would not provide an exemption for an independent contractor-entertainer, athlete. Under the French treaty, the definition of "industrial and commercial profits" is much broader. It includes income derived from the "furnishing of personal services." However, it does not include "income received by an individual as compensation for personal services either as an employee or in an independent capacity."[49] The employer would thus be exempt on income received from personal services unless he has a permanent establishment in the United States. The employee or independent contractor would look to the commercial traveler exclusion. As noted previously, the commercial traveler provision provided in the French treaty is very liberal with respect to an independent contractor.

If the income is within the definition above, there must be a permanent establishment in the United States for the profits to be taxable to the foreign entity. Under the Swiss treaty, a permanent establishment does not include the mere presence in the United States of an agent "unless the agent has and habitually exercises, a general authority to negotiate and conclude contracts on behalf of [the Swiss] enterprise or has a stock of merchandise from which it regularly fills orders on its behalf."[50] The French treaty definition includes a person (other than an independent agent) acting on behalf of a French resident if such person "(a) [h]as and habitually exercises in [the United States] an authority to conclude contracts in the name of that resident, unless the exercise of such authority is limited to the purchase of goods or merchandise for that resident or (b) maintains substantial equipment or merchandise within the [United States] for a period of twelve months or more."[51] There is an obvious distinction between the Swiss treaty and French treaty relative to a purchasing agent.

The exception for "industrial and commercial profits" is extremely important to any proper planning where the treaty either allows for an exemption for personal services or where the services are part of an overall product which could bring the income within the "commercial and industrial profits" exclusion. A corporation, for example, selling a product and certain engineering services may be able to exclude the income on the service portion where there is no "permanent establishment" in the United States. Without the treaty, the personal service alone would result in a trade or business and subject the entity to tax in the United States. A typical treaty would not find a permanent establishment in the United States solely on the rendering of services in the United States. If the employer is in a nontreaty country or if the treaty is unfavorable, it is always a possibil-

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[49]U.S.-French Income Tax Convention, *supra* note 30, Article 6(6).
[50]U.S.-Swiss Income Tax Convention, *supra* note 27, Article II(1)(c).
[51]U.S.-French Income Tax Convention, *supra* note 30, Article 4(4).

ity to set up a subsidiary corporation in a treaty country which could be the employer company. By combining the "commercial and industrial profits" exclusion along with the "commercial traveler" exclusion, you may exempt both the employer and the employee on earnings and compensation which would otherwise be U.S. source income.

Taxation of Nonresident Alien

The method of computing and the rate of tax on income will depend upon whether there is a trade or business. Income which is not effectively connected with a trade or business will be taxable on the gross amount received with no deductions. Absent a treaty, the rate will be 30 percent.[52] This would include compensation. There will be no personal exemption allowed in computing taxable income.[53] The reduction in rates provided by the treaty generally applies to dividends, interest and royalties. If the alien receives only income which is subject to withholding, and the withholding is adequate to cover the tax, no income tax return will be required.[54]

If at any time during the year, the alien is engaged in a trade or business, a return will be required.[55] An alien engaged in a trade or business will be allowed deductions to the extent they are "connected with income which is effectively connected."[56] Traveling expenses would be deductible to a nonresident alien working in the United States where his tax home remains outside the United States.[57] Moving expenses incurred in coming to the United States are allowable if the requirements under the Code are met.[58] This probably would not be allowable to an individual who remains a nonresident alien and whose home remained outside of the United States. Moving expenses incurred in moving back are generally not deductible.[59] State income taxes on effectively connected income are also held to be deductible.[60] The alien may also claim deductions for contributions to certain qualified retirement plans.[61] In computing the taxable income, the NRA is not allowed to use the "zero bracket" amount.[62] The Code also provides a prerequisite for the alien to receive the deductions. The alien must file a "true and accurate return."[63] Presumably, if the return is not filed, the alien will be taxable on his gross income.

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[52]26 U.S.C. § 871(a)(1) (1976).
[53]26 U.S.C. § 873 (1976 & Supp. I 1977).
[54]26 U.S.C. § 6012(a) (1972); Treas. Reg. § 1.6012-1(b) (1959).
[55]Treas. Reg. § 1.6012-1(b)(3).
[56]26 U.S.C. § 873(a) (1976).
[57]Rev. Rul. 73-578, 1973-2 C.B. 162.
[58]Rev. Rul. 68-308, 1968-1 C.B. 336.
[59]Rev. Rul. 75-84, 1975-1 C.B. 236; Rev. Rul. 75-85, 1975-1 C.B. 239.
[60]Rev. Rul. 73-402, 1973-2 C.B. 227.
[61]I.R.S. PUB. 519, U.S. TAX GUIDE FOR ALIENS, 23 (1979).
[62]26 U.S.C. § 63(e)(1)(B) (Supp. I 1977).
[63]26 U.S.C. § 874(a) (1976).

In addition to his effectively connected deductions, he will also be allowed deductions for casualties or theft losses allowable under section 165(c)(3) of the Code on property located in the United States, and for charitable contributions allowable under section 170.[64]

The NRA engaged in a trade or business will be taxed at the graduated rates provided under section 1 of the Code.[65] A NRA may not qualify for the favorable rates provided for the head of a household.[66] A married NRA will also have the additional problem regarding his filing status. If the alien is married to a NRA, he must file as a married individual filing separately.[67] If he is married to a U.S. citizen or a U.S. resident, he may file a joint return if the NRA elects to be treated as a resident for all income.[68] The alien will also be denied the use of "income averaging," another special provision for favorable tax treatment. This provision may also be denied an individual who becomes a resident because the income averaging provisions are denied the RA who during any of the four previous years was a NRA.[69] In addition, the NRA engaged in a trade or business will be allowed only one exemption unless the alien is a resident of Canada or Mexico or is a U.S. national.[70] This may also be modified by treaty. A return is required by every NRA engaged in a trade or business at any time during the taxable year.[71]

In reviewing the above, three significant points should be noted. The first is the application of a flat rate of tax on fixed or determinable income where there is no trade or business, the second is that graduated rates apply where there is trade or business income in a year in which services are performed and third is that you will have fixed or determinable income if it is received in a year in which no services are performed. Thus, depending upon the amount of compensation that an individual is to receive, he may specifically elect to receive income (within certain parameters relative to the constructive receipt theory) to defer certain compensation income into a year in which no trade or business is conducted in the United States if the flat 30 percent rate would be beneficial. On the other hand, if the income would be taxed at an effective rate of less than 30 percent, it would be beneficial to be certain that the income was received in a year in which services were rendered. Another consideration is the use of deductions. The effectively connected deduction can only be used in a year in which there is a trade or business. Proper planning must take into consideration each of these items.

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[64]26 U.S.C. § 873(b) (1976).
[65]26 U.S.C. § 871(b) (1976).
[66]26 U.S.C. § 2(b)(3)(A) (1976).
[67]26 U.S.C. § 6013(a)(1) (1976).
[68]26 U.S.C. § 6013(g) (1976).
[69]26 U.S.C. § 1303(b) (1976).
[70]26 U.S.C. § 873(b)(3) (1976).
[71]Treas. Reg. § 1.6012-1(b)(3) (1957).

Witholding on U.S. Source Personal Service Income

Compensation paid to a NRA employee is generally subject to regular withholding on a graduated basis under section 3402. Where the income is exempt by the Code or under a treaty, withholding may not be required.[72] Compensation paid to the NRA who is an independent contractor will generally be subject to withholding at a flat 30 percent.[73]

Analysis of Forms of Deferred Compensation

A. *Deferred Payments*

As stated previously, the commercial traveler provision of the Code applies to the year services are performed. If income is received in a year subsequent to the performance of the services, the $3,000 exclusion provided in the Code will be measured as of the year in which the services are performed regardless of when they are paid. If no services are performed and payments are received in a subsequent year, compensation will be fixed or determinable and will be taxed at 30 percent with no deductions allowed. This may be beneficial depending upon what the individual's tax rate would have been for the year in which the income was earned and whether there are any deductions which might be taken in the year the services are performed.

The treaty will generally continue to exempt deferred payments where there has been compliance with the commercial traveler rules. This should be true if the individual is not present in the United States for more than 183 days during the year in which the payment is received. It may not be clear whether the 183 day rule will have to be complied with in the year of service as well as the year of payment. This is likely to depend on the treaty.

B. *Periodic Distributions under Retirement Plans*

As previously stated, the source rules apply to deferred compensation as well as current compensation.[74] In analyzing the taxation on distributions from a retirement plan, there is a distinction between the principal distribution and the earnings or interest portion of the distribution. The Code provides an exclusion if the employer contribution would not have been includible in gross income if paid to the employee at the time of contribution. The contribution will be treated as part of the employee's investment in the contract.[75] This exclusion will apply to contributions attributable to: (a) Services performed outside the United States; and (b) Compensation excluded under the Code or a treaty commercial traveler rule.

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[72]Treas. Reg. § 31.3401(a)(6)–1(e) (1966).
[73]26 U.S.C. § 1441(a) (1976); Treas. Reg. § 1.1441-4(a)(1) (1956).
[74]Treas. Reg. § 1.861–4(a)(1), T.D. 7378, 1975–2 C.B. 272.
[75]26 U.S.C. § 72(f)(2) (1976).

It would generally not apply to contributions for services performed for a U.S. employer. This exclusion, however, would apply to payments received by an individual who was a RA at the time of payment. The portion that is taxable would be treated as fixed or determinable income and taxed at 30 percent.

The source of the "interest" component is the situs of the trust. If the situs of the trust is in the United States, the interest component is from U.S. sources.[76] The situs of the trust is usually a question of fact.[77] If the trust is created under foreign law, but administered in the United States, it may be a U.S. trust.[78] A trust created under foreign law and administered under that foreign jurisdiction would result in foreign source income on the interest component. In addition, the Code also provides a complete exemption on the entire amount distributed from the plan if it is a qualified plan and if:

(i) All services were performed outside the U.S. (or was excluded under the commercial traveler rules) and
(ii) At least 90% of the plan participants are U.S. citizens or resident aliens when the non-resident alien receives his first distribution.[79]

Treaties usually provide an exemption for pensions and annuities. Under the Swiss treaty, private pensions derived from the United States and paid to an individual residing in Switzerland will be exempt from U.S. tax.[80] The treaty generally defines the pension to mean a periodic payment made in consideration for services rendered.[81] It does not appear that the payment must be from a plan approved by the IRS. The regulations under the treaty also indicate that the exemption applies even though the individual is engaged in a trade or business through a permanent establishment at some time during the year payment is received.[82] The French treaty provides the same general exemption as the Swiss treaty.[83] It, however, specifically provides that the term "pension" means a periodic payment made after retirement.[84] It seems reasonable that the "after retirement" provision would apply in the Swiss treaty although it is not specifically stated.

The above discussion, of course, relates to periodic payments. Frequently, retirement plans provide for lump sum distribution. The amount subject to tax under the Code should be the same as the periodic distribution.[85] The distribution, however, which includes contributions for years prior to 1974 will contain a capital gain portion of the pre-1974 portion. If

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[76]U.S. TAX GUIDE FOR ALIENS, *supra*, note 61, at 4.
[77]*Cf.* B.W. Jones Trust 46 B.T.A. 531 (1942); *aff'd*, 132 F.2d 914 (4th Cir. 1943).
[78]Rev. Rul. 70-242, 1970-1 C.B. 89.
[79]26 U.S.C. § 871(f) (1976 & Supp. IV 1980).
[80]U.S.-Swiss Income Tax Treaty, *supra* note 27, Article XI(2).
[81]U.S.-Swiss Income Tax Treaty, *supra* note 27, Article XI(3).
[82]26 C.F.R. § 509.114(a).
[83]U.S.-French Income Tax Treaty, *supra* note 30, Article 19.
[84]U.S.-French Income Tax Treaty, *supra* note 30, Article 19(4).
[85]26 U.S.C. §§ 72(f)(2) and 402 (1976).

the NRA is engaged in a trade or business in the year of receipt, the distribution will be "effectively connected."[86] The ordinary income portion could be taxed by using the ten-year averaging rules.[87] The capital gain portion will be taxable as a long-term capital gain subject to the deduction for 60 percent under section 1202.[88] If, on the other hand, there is no trade or business in the year of distribution, the proceeds will be taxed at 30 percent. This includes the capital gain portion.[89] The ordinary income portion is also held to be "fixed or determinable, annual or periodical" and taxed at 30 percent even though there is only one payment.[90] The ten-year averaging rules will not apply.

Treaties usually define pensions to be retirement benefits paid as "periodic payments." Does a lump sum distribution qualify? As to the capital gain portion, the IRS has taken the position in at least one case that this is not a pension.[91] The French treaty, like many other treaties, provides an exemption for a capital gain where the individual is not in the United States more than 183 days and does not have a fixed base to which the gain is effectively connected.[92] Logically, the ordinary income portion of the lump sum distribution should come within the treaty exemption for pensions. If there is no trade or business, the only alternative for the IRS is to argue that it is "fixed or determinable, annual or periodical."

The treaty exemption from U.S. tax for pensions could provide an important part of anyone's overall tax planning. The treaties generally do not provide that the individual be a resident of the treaty country at the time the services are performed. As also stated, it does not appear that the plan from which the distribution is made be a qualified plan. Each treaty must be analyzed for particular requirements. It appears that in many cases, the purchase of an annuity by the employer, under a reasonable deferral plan, which is then distributed after retirement could escape U.S. taxation.

Summary

In planning the compensation for any NRA, it is essential to be familiar with the taxation of the country of residence of the alien. With respect to U.S. taxation, however, the following items must be considered:

1. Will the alien's contact with the United States be limited sufficiently to be classified as a NRA?
2. What is the source of the payment?
3. Will the Code provide any exemption?
4. Will a treaty apply which will provide an exemption?

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[86]Treas. Reg. § 1.864–4(c)(6). T.D. 7378, 1975–2 C.B. 272.
[87]26 U.S.C. §§ 402(e)(1) and 871(b) (1976 & Supp. II 1978).
[88]26 U.S.C. §§ 401(a)(2) (1976 & Supp. IV 1980) and 403(a)(2) (1976 & Supp. IV 1980).
[89]26 U.S.C. § 871(a)(1)(B) (1976).
[90]Commissioner v. Wodehouse, 337 U.S. 369, 393 (1949).
[91]Rev. Rul. 58–248, 1958–1 C.B. 621 (Australia).
[92]U.S.–French Income Tax Convention, *supra* note 30, Article 12.

5. Will services be performed in the year of payment?

6. Can the payment be shifted to a year in which services are not performed?

7. Will there be deductions which are "effectively connected" to the compensation?

8. What is the effective rate of taxation for the alien?

9. Will a treaty provide any relief for the income received by the employer?

10. Is the individual performing the personal services as an employee or an independent contractor?

11. Can the compensation be deferred?

The obvious planning techniques are to find an exemption for the income or to shift the income from a high rate year to a lower rate year. Because the rate may be a graduated rate or a flat 30 percent rate, the compensation, unlike dividend or interest income, is subject to a much greater fluctuation in taxation and thus, has many more planning techniques available to it.