

[Federal Register: July 14, 2005 (Volume 70, Number 134)]

[Rules and Regulations]

[Page 40663-40669]

From the Federal Register Online via GPO Access [[wais.access.gpo.gov](http://wais.access.gpo.gov)]

[DOCID:fr14jy05-6]

---

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9212]

RIN **1545-A072**

Source of Compensation for Labor or Personal Services

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

---

SUMMARY: This document contains final regulations that describe the proper basis for determining the source of compensation for labor or personal services performed partly within and partly without the United States. These final regulations will affect individuals who earn compensation for labor or personal services performed partly within and partly without the United States and are needed to provide appropriate guidance regarding the determination of the proper source of that compensation.

DATES: Effective Date: These regulations are effective July 14, 2005.

Applicability Date: For dates of applicability, see Sec. 1.861-4(d).

FOR FURTHER INFORMATION CONTACT: David Bergkuist, (202) 622-3850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number **1545-1900**.

The collections of information in these final regulations are in Sec. 1.861-4(b)(2) (ii)(C)(1)(i), (b)(2)(ii)(D), and (b)(2)(ii)(D)(6). The information required in Sec. 1.861-4(b)(2) (ii)(C)(1)(i) will enable an individual, where appropriate, to use an alternative basis other than that described in Sec. 1.861-4(b)(2)(ii)(A) or (B) to determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the United States. The information required in Sec. 1.861-4(b)(2)(ii)(D) and (D)(6) will enable an employee to source certain fringe benefits on a geographical basis. The collections of information will, likewise, allow the IRS to verify these determinations.

An agency may not conduct or sponsor, and a person is not required to

[[Page 40664]]

respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## Background

This document contains amendments to 26 CFR part 1. On August 6, 2004, proposed revisions to the regulations (REG-208254-90) under section 861 of the Internal Revenue Code (Code) relating to the source of compensation for labor or personal services were published in the Federal Register (69 FR 47816). In the same document, a prior notice of proposed rulemaking (REG-208254-90), published in the Federal Register on January 21, 2000 (65 FR 3401), was withdrawn. A public hearing was held on January 13, 2005. Two written comments were received. After consideration of these comments, the August 6, 2004 proposed regulations are adopted as amended by this Treasury decision.

## Summary of Comments and Explanation of Revisions

These final regulations, as proposed in the notice of proposed rulemaking, retain the facts and circumstances basis as the general rule for determining the source of compensation for labor or personal services performed partly within and partly without the United States received by persons other than individuals and by individuals who are not employees. As proposed, the final regulations provide two general bases for determining the proper source of compensation that an individual receives as an employee for such labor or personal services. Under the first general basis of Sec. 1.861-4(b)(2)(ii)(A), an individual will source compensation, other than compensation in the form of certain fringe benefits, on a time basis, as defined in Sec. 1.861-4(b)(2)(ii)(E).

Under the second general basis of Sec. 1.861-4(b)(2)(ii)(B) and (D), an individual will source compensation in the form of fringe benefits, as described in Sec. 1.861-4(b)(2)(ii)(D)(1) through (6), on a geographical basis (e.g., at the employee's principal place of work, as defined in section 217 and Sec. 1.217-2(c)(3)). The fringe benefits to which this general basis applies are housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement fringe benefits. This general basis will apply only if the amount of the fringe benefit is reasonable and is substantiated by adequate contemporaneous records or sufficient evidence under rules similar to those set forth in Sec. 1.274-5T(c) or (h) or Sec. 1.132-5.

Comments were received that proposed several changes with regard to the fringe benefits described in Sec. 1.861-4(b)(2)(ii)(D)(1) through (6). Under one suggestion, the specific definitions of the identified fringe benefits would be replaced with broad categories. The comment further suggested that the housing fringe benefit, education fringe benefit, and local transportation fringe benefit include employer-provided allowances that are based on estimated, rather than actual, expenses. The comment also requested that the definition of education fringe benefit be expanded to include payments for the education of the employee's spouse for studies that relate to the foreign location of the employment, such as language courses and job training at the foreign location, and to include pre-school and post-secondary education, home schooling costs, and language courses of the employee's dependents. With respect to the transportation fringe benefit, the comment requested that automobile purchase assistance in the host country be included. The comment also requested that the amount of compensation qualifying for the hazardous or hardship duty pay fringe benefit not be limited to government-provided amounts. The comment suggested that the definition of moving expense reimbursement fringe

benefit be expanded to include a list of specific expenses, such as moving allowances, home sale/purchase assistance, temporary living, car loss reimbursement, utility setup, appliance installation, auto registration, driver's license fees, power converters, and other related expenses. The comment also suggested three additional fringe benefits: home leave allowances, cost-of-living allowances, and exchange rate differential allowances.

The Treasury Department and the IRS considered the various comments regarding the approach, scope, and detail of the identified fringe benefits under the proposed regulations. In response to the comments, the final regulations modify the definition of education fringe benefit to include education expenses of the type described in section 530(b)(4)(A)(i) regardless of whether the education expenses are incurred in connection with enrollment or attendance at a school. The final regulations do not incorporate the suggestion for allowances based on estimated expenses because the Treasury Department and the IRS continue to believe that substantiation of relevant items is the more appropriate approach. Regarding the other proposed changes to the identified fringe benefits, the Treasury Department and the IRS believe that the regulations provide an appropriate scope of benefits, a reasonable manner of determining the appropriate amount of fringe benefit to be sourced geographically, and a reasonable limit to the amount of an individual's compensation that may be sourced under the exception to the general time basis rule of Sec. 1.861-4(b)(2)(ii)(E). As noted in the preamble to the proposed regulations, the Treasury Department and the IRS intend to keep the list and descriptions of identified fringe benefits current and continue to invite comments on whether the identified fringe benefits are appropriately defined and whether other fringe benefits should be identified and sourced on a specific geographic basis.

Furthermore, the final regulations retain the proposed provision that permits an employee to use an alternative basis, based upon the facts and circumstances, to source such compensation if he or she establishes to the satisfaction of the Commissioner that such an alternative basis more properly determines the source of the compensation. An individual seeking to use an alternative basis need not obtain the satisfaction of the Commissioner prior to filing his or her return. To obtain the satisfaction of the Commissioner, an individual who uses an alternative basis must retain in his or her records documentation setting forth why the alternative basis more properly determines the source of the compensation than the basis for determining source of compensation described in Sec. 1.861-4(b)(2)(ii)(A) or (B). One comment requested that substantiation by the individual's employer be accepted as substantiation by the employee,

particularly where the alternative method is used by a group of employees. Whether an alternative basis more properly determines the source of an individual's compensation is based on the facts and circumstances of the individual's specific case. As a result, it is the individual employee, rather than the employer, who must demonstrate that the alternative basis more properly determines the source of the compensation than the basis for determining source of compensation described in Sec. 1.861-4(b)(2)(ii)(A) or (B). It is expected, however, that the

[[Page 40665]]

individual employee would use, among other documentation, documentation provided by the employer for such substantiation.

Another comment requested relief from any penalties that might arise from inaccurate reporting or withholding if an alternative method is determined not to be acceptable or if the Commissioner determines that a method other than the two general methods determines the source of compensation in a more reasonable manner. The Treasury Department and the IRS believe that the existing standards of penalty administration, including applicable justifications, adequately address this matter.

Section 1.861-4(b)(2)(ii)(C)(1)(i) of the proposed regulations provided that to assert an alternative basis the individual must comply with the requirements set forth in any administrative pronouncement issued by the Commissioner. The final regulations require that to assert an alternative basis, the individual must provide the information related to the alternative basis required by applicable Federal tax forms and accompanying instructions. It is expected that the applicable Federal tax forms and accompanying instructions will require individuals with \$250,000 or more in compensation for the tax year that use an alternative basis to respond to questions on the tax form and to attach to their income tax returns a written statement that sets forth: (1) The specific compensation income, or the specific fringe benefit, for which an alternative method is used; (2) for each such item, the alternative method of allocation of source used; (3) for each such item, a computation showing how the alternative allocation was computed; and (4) a comparison of the dollar amount of the compensation sourced within and without the United States under both the individual's alternative basis and the basis for determining source of compensation described in Sec. 1.861-4(b)(2)(ii)(A) or (B).

The proposed regulations at Sec. 1.861-4(b)(2)(ii)(C)(3) were reserved with respect to artists and athletes who are employees. Although requested, no comments were received on the definition of

artists and athletes. The reservation is retained in these final regulations. As noted in the preamble to the proposed regulation, it is intended that the specific rules for artists and athletes who are employees, when issued, will require such individuals to determine the proper source of compensation for labor or personal services on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case, consistent with current law.

Proposed Sec. 1.861-4(b)(2)(ii)(F) provided that the source of multi-year compensation of an employee is generally determined on a time basis over the applicable period to which the compensation is attributable. Determination of the applicable period to which the compensation is attributable (including whether the compensation relates to more than one taxable year) is based upon the facts and circumstances of the particular case. Comments requested additional guidance in the area of equity based compensation, particularly with respect to stock options, that relate to services performed over a period of more than one year. These comments requested guidance related to pre-grant sourcing, sourcing based upon exercise date, and non-conventional equity compensation awards. Because under the regulations the applicable period is determined based on the facts and circumstances of the particular case, and a taxpayer may assert an alternative method to source such compensation income pursuant to Sec. 1.861-4(b)(2)(ii)(C)(1)(i), the Treasury Department and the IRS concluded that Sec. 1.861-4(b)(2)(ii)(F), as proposed, was reasonable in its scope and the rules were not modified in the final regulations.

## Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collections of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based upon that fact that the Treasury Department and the IRS believe that a time basis generally is the most appropriate method for determining the source of an individual employee's compensation for labor or personal services performed partly within and partly without the United States. The information necessary to apply the time basis should be readily available to employers and employees. For example, Form 2555, ``Foreign Earned Income'', requires an individual who claims the foreign earned income exclusion to provide the IRS with information relating to the

number of business days spent within the United States and any fringe benefits received. In addition, if an employee wishes to use an alternative method to source compensation, it is the employee that must document such alternative method. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### Drafting Information

The principal author of these final regulations is David Bergkuist of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

#### List of Subjects

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 602

Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

0

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

##### PART 1--INCOME TAXES

0

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 \* \* \*

0

Par. 2. Section 1.861-4 is amended as follows:

0

1. The heading for paragraph (a) is revised.

0

2. A sentence is added at the beginning of paragraph (a)(1) introductory text.

0

3. Paragraph (b) is revised.

0

4. A sentence is added at the end of paragraph (d).

The revisions and addition read as follows:

Sec. 1.861-4 Compensation for labor or personal services.

(a) Compensation for labor or personal services performed wholly within the United States. (1) Generally, compensation for labor or personal services, including fees, commissions, fringe benefits, and similar items, performed wholly within the United States is gross income from sources within the United States. \* \* \*

\* \* \* \* \*

(b) Compensation for labor or personal services performed partly within and partly without the United States--(1) Compensation for labor or

[[Page 40666]]

personal services performed by persons other than individuals--(i) In general. In the case of compensation for labor or personal services performed partly within and partly without the United States by a person other than an individual, the part of that compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on the time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) Example. The application of paragraph (b)(1)(i) is illustrated by the following example.

Example. Corp X, a domestic corporation, receives compensation of \$150,000 under a contract for services to be performed concurrently in the United States and in several foreign countries



by numerous Corp X employees. Each Corp X employee performing services under this contract performs his or her services exclusively in one jurisdiction. Although the number of employees (and hours spent by employees) performing services under the contract within the United States equals the number of employees (and hours spent by employees) performing services under the contract without the United States, the compensation paid to employees performing services under the contract within the United States is higher because of the more sophisticated nature of the services performed by the employees within the United States. Accordingly, the payroll cost for employees performing services under the contract within the United States is \$20,000 out of a total contract payroll cost of \$30,000. Under these facts and circumstances, a determination based upon relative payroll costs would be the basis that most correctly reflects the proper source of the income received under the contract. Thus, of the \$150,000 of compensation included in Corp X's gross income, \$100,000 ( $\$150,000 \times \$20,000/\$30,000$ ) is attributable to the labor or personal services performed within the United States and \$50,000 ( $\$150,000 \times \$10,000/\$30,000$ ) is attributable to the labor or personal services performed without the United States.

(2) Compensation for labor or personal services performed by an individual--(i) In general. Except as provided in paragraph (b)(2)(ii) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on the basis that most correctly reflects the proper source of that income under the facts and circumstances of the particular case. In many cases, the facts and circumstances will be such that an apportionment on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, will be acceptable.

(ii) Employee compensation--(A) In general. Except as provided in paragraph (b)(2)(ii)(B) or (C) of this section, in the case of compensation for labor or personal services performed partly within and partly without the United States by an individual as an employee, the part of such compensation that is attributable to the labor or personal services performed within the United States, and that is therefore included in gross income as income from sources within the United States, is determined on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section.

(B) Certain fringe benefits sourced on a geographical basis. Except

as provided in paragraph (b)(2)(ii)(C) of this section, items of compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States that are described in paragraphs (b)(2)(ii)(D)(1) through (6) of this section are sourced on a geographical basis in accordance with those paragraphs.

(C) Exceptions and special rules--(1) Alternative basis--(i) Individual as an employee generally. An individual may determine the source of his or her compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis if the individual establishes to the satisfaction of the Commissioner that, under the facts and circumstances of the particular case, the alternative basis more properly determines the source of the compensation than a basis described in paragraph (b)(2)(ii)(A) or (B), whichever is applicable, of this section. An individual that uses an alternative basis must retain in his or her records documentation setting forth why the alternative basis more properly determines the source of the compensation. In addition, the individual must provide the information related to the alternative basis required by applicable Federal tax forms and accompanying instructions.

(ii) Determination by Commissioner. The Commissioner may, under the facts and circumstances of the particular case, determine the source of compensation that is received by an individual as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis other than a basis described in paragraph (b)(2)(ii)(A) or (B) of this section if such compensation either is not for a specific time period or constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D) of this section notwithstanding a failure to meet any requirement of paragraph (b)(2)(ii)(D) of this section. The Commissioner may make this determination only if such alternative basis determines the source of compensation in a more reasonable manner than the basis used by the individual pursuant to paragraph (b)(2)(ii)(A) or (B) of this section.

(2) Ruling or other administrative pronouncement with respect to groups of taxpayers. The Commissioner may, by ruling or other administrative pronouncement applying to similarly situated taxpayers generally, permit individuals to determine the source of their compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis. Any such individual shall be treated as having met the requirement to establish such alternative basis to the satisfaction of the Commissioner under the facts and circumstances of the particular case, provided that the individual meets the other requirements of

paragraph (b)(2)(ii)(C)(1)(i) of this section. The Commissioner also may, by ruling or other administrative pronouncement, indicate the circumstances in which he will require individuals to determine the source of certain compensation as an employee for labor or personal services performed partly within and partly without the United States under an alternative basis pursuant to the authority under paragraph (b)(2)(ii)(C)(1)(ii) of this section.

(3) Artists and athletes. [Reserved.]

(D) Fringe benefits sourced on a geographical basis. Except as provided in paragraph (b)(2)(ii)(C) of this section, compensation of an individual as an employee for labor or personal services performed partly within and partly without the United States in the form of the following fringe benefits is sourced on a geographical basis as indicated in this paragraph (b)(2)(ii)(D). The amount of the compensation in the form of the fringe benefit must be reasonable, and the individual must substantiate such amounts by adequate records or by sufficient evidence under rules similar to those set forth in Sec. 1.274-5T(c) or (h) or Sec. 1.132-5. For purposes of this paragraph (b)(2)(ii)(D), the term principal place of work has the same

[[Page 40667]]

meaning that it has for purposes of section 217 and Sec. 1.217-2(c)(3).

(1) Housing fringe benefit. The source of compensation in the form of a housing fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(1), a housing fringe benefit includes payments to or on behalf of an individual (and the individual's family if the family resides with the individual) only for rent, utilities (other than telephone charges), real and personal property insurance, occupancy taxes not deductible under section 164 or 216(a), nonrefundable fees paid for securing a leasehold, rental of furniture and accessories, household repairs, residential parking, and the fair rental value of housing provided in kind by the individual's employer. A housing fringe benefit does not include payments for expenses or items set forth in Sec. 1.911-4(b)(2).

(2) Education fringe benefit. The source of compensation in the form of an education fringe benefit for the education expenses of the individual's dependents is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(2), an education fringe benefit includes payments only for qualified tuition and expenses of the type described in section 530(b)(4)(A)(i) (regardless of whether incurred in connection with

enrollment or attendance at a school) and expenditures for room and board and uniforms as described in section 530(b)(4)(A)(ii) with respect to education at an elementary or secondary educational institution.

(3) Local transportation fringe benefit. The source of compensation in the form of a local transportation fringe benefit is determined based on the location of the individual's principal place of work. For purposes of this paragraph (b)(2)(ii)(D)(3), an individual's local transportation fringe benefit is the amount that the individual receives as compensation for local transportation of the individual or the individual's spouse or dependents at the location of the individual's principal place of work. The amount treated as a local transportation fringe benefit is limited to the actual expenses incurred for local transportation and the fair rental value of any vehicle provided by the employer and used predominantly by the individual or the individual's spouse or dependents for local transportation. For this purpose, actual expenses incurred for local transportation do not include the cost (including interest) of the purchase by the individual, or on behalf of the individual, of an automobile or other vehicle.

(4) Tax reimbursement fringe benefit. The source of compensation in the form of a foreign tax reimbursement fringe benefit is determined based on the location of the jurisdiction that imposed the tax for which the individual is reimbursed.

(5) Hazardous or hardship duty pay fringe benefit. The source of compensation in the form of a hazardous or hardship duty pay fringe benefit is determined based on the location of the hazardous or hardship duty zone for which the hazardous or hardship duty pay fringe benefit is paid. For purposes of this paragraph (b)(2)(ii)(D)(5), a hazardous or hardship duty zone is any place in a foreign country which is either designated by the Secretary of State as a place where living conditions are extraordinarily difficult, notably unhealthy, or where excessive physical hardships exist, and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. Government present at that place, or where a civil insurrection, civil war, terrorism, or wartime conditions threatens physical harm or imminent danger to the health and well-being of the individual. Compensation provided an employee during the period that the employee performs labor or personal services in a hazardous or hardship duty zone may be treated as a hazardous or hardship duty pay fringe benefit only if the employer provides the hazardous or hardship duty pay fringe benefit only to employees performing labor or personal services in a hazardous or hardship duty zone. The amount of compensation treated as a

hazardous or hardship duty pay fringe benefit may not exceed the maximum amount that the U.S. government would allow its officers or employees present at that location.

(6) Moving expense reimbursement fringe benefit. Except as otherwise provided in this paragraph (b)(2)(ii)(D)(6), the source of compensation in the form of a moving expense reimbursement is determined based on the location of the employee's new principal place of work. The source of such compensation is determined based on the location of the employee's former principal place of work, however, if the individual provides sufficient evidence that such determination of source is more appropriate under the facts and circumstances of the particular case. For purposes of this paragraph (b)(2)(ii)(D)(6), sufficient evidence generally requires an agreement, between the employer and the employee, or a written statement of company policy, which is reduced to writing before the move and which is entered into or established to induce the employee or employees to move to another country. Such written statement or agreement must state that the employer will reimburse the employee for moving expenses that the employee incurs to return to the employee's former principal place of work regardless of whether he or she continues to work for the employer after returning to that location. The writing may contain certain conditions upon which the right to reimbursement is determined as long as those conditions set forth standards that are definitely ascertainable and can only be fulfilled prior to, or through completion of, the employee's return move to the employee's former principal place of work.

(E) Time basis. The amount of compensation for labor or personal services performed within the United States determined on a time basis is the amount that bears the same relation to the individual's total compensation as the number of days of performance of the labor or personal services by the individual within the United States bears to his or her total number of days of performance of labor or personal services. A unit of time less than a day may be appropriate for purposes of this calculation. The time period for which the compensation for labor or personal services is made is presumed to be the calendar year in which the labor or personal services are performed, unless the taxpayer establishes to the satisfaction of the Commissioner, or the Commissioner determines, that another distinct, separate, and continuous period of time is more appropriate. For example, a transfer during a year from a position in the United States to a foreign posting that lasted through the end of that year would generally establish two separate time periods within that taxable year. The first of these time periods would be the portion of the year preceding the start of the foreign posting, and the second of these

time periods would be the portion of the year following the start of the foreign posting. However, in the case of a foreign posting that requires short-term returns to the United States to perform services for the employer, such short-term returns would not be sufficient to establish distinct, separate, and continuous time periods within the foreign posting time period but would be relevant to the allocation of compensation relating to the overall

[[Page 40668]]

time period. In each case, the source of the compensation on a time basis is based upon the number of days (or unit of time less than a day, if appropriate) in that separate time period.

(F) Multi-year compensation arrangements. The source of multi-year compensation is determined generally on a time basis, as defined in paragraph (b)(2)(ii)(E) of this section, over the period to which such compensation is attributable. For purposes of this paragraph (b)(2)(ii)(F), multi-year compensation means compensation that is included in the income of an individual in one taxable year but that is attributable to a period that includes two or more taxable years. The determination of the period to which such compensation is attributable, for purposes of determining its source, is based upon the facts and circumstances of the particular case. For example, an amount of compensation that specifically relates to a period of time that includes several calendar years is attributable to the entirety of that multi-year period. The amount of such compensation that is treated as from sources within the United States is the amount that bears the same relationship to the total multi-year compensation as the number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed within the United States in connection with the project bears to the total number of days (or unit of time less than a day, if appropriate) that labor or personal services were performed in connection with the project. In the case of stock options, the facts and circumstances generally will be such that the applicable period to which the compensation is attributable is the period between the grant of an option and the date on which all employment-related conditions for its exercise have been satisfied (the vesting of the option).

(G) Examples. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. B, a nonresident alien individual, was employed by Corp M, a domestic corporation, from March 1 to December 25 of the taxable year, a total of 300 days, for which B received compensation

in the amount of \$80,000. Under B's employment contract with Corp M, B was subject to call at all times by Corp M and was in a payment status on a 7-day week basis. Pursuant to that contract, B performed services (or was available to perform services) within the United States for 180 days and performed services (or was available to perform services) without the United States for 120 days. None of B's \$80,000 compensation was for fringe benefits as identified in paragraph (b)(2)(ii)(D) of this section. B determined the amount of compensation that is attributable to his labor or personal services performed within the United States on a time basis under paragraph (b)(2)(ii)(A) and (E) of this section. B did not assert, pursuant to paragraph (b)(2)(ii)(C)(1)(i) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the time basis. Therefore, B must include in income from sources within the United States \$48,000 ( $\$80,000 \times 180/300$ ) of his compensation from Corporation M.

Example 2. (i) Same facts as in Example 1 except that Corp M had a company-wide arrangement with its employees, including B, that they would receive an education fringe benefit, as described in paragraph (b)(2)(ii)(D)(2) of this section, while working in the United States. During the taxable year, B incurred education expenses for his dependent daughter that qualified for the education fringe benefit in the amount of \$10,000, for which B received a reimbursement from Corp M. B did not maintain adequate records or sufficient evidence of this fringe benefit as required by paragraph (b)(2)(ii)(D) of this section. When B filed his Federal income tax return for the taxable year, B did not apply paragraphs (b)(2)(ii)(B) and (D)(2) of this section to treat the compensation in the form of the education fringe benefit as income from sources within the United States, the location of his principal place of work during the 300-day period. Rather, B combined the \$10,000 reimbursement with his base compensation of \$80,000 and applied the time basis of paragraph (b)(2)(ii)(A) of this section to determine the source of his gross income.

(ii) On audit, B argues that because he failed to substantiate the education fringe benefit in accordance with paragraph (b)(2)(ii)(D) of this section, his entire employment compensation from Corp M is sourced on a time basis pursuant to paragraph (b)(2)(ii)(A) of this section. The Commissioner, after reviewing Corp M's fringe benefit arrangement, determines, pursuant to paragraph (b)(2)(ii)(C)(1)(ii) of this section, that the \$10,000 educational expense reimbursement constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D)(2) of this section,

notwithstanding a failure to meet all of the requirements of paragraph (b)(2)(ii)(D) of this section, and that an alternative geographic source basis, under the facts and circumstances of this particular case, is a more reasonable manner to determine the source of the compensation than the time basis used by B.

Example 3. (i) A, a United States citizen, is employed by Corp N, a domestic corporation. A's principal place of work is in the United States. A earns an annual salary of \$100,000. During the first quarter of the calendar year (which is also A's taxable year), A performed services entirely within the United States. At the beginning of the second quarter of the calendar year, A was transferred to Country X for the remainder of the year and received, in addition to her annual salary, \$30,000 in fringe benefits that are attributable to her new principal place of work in Country X. Corp N paid these fringe benefits separately from A's annual salary. Corp N supplied A with a statement detailing that \$25,000 of the fringe benefit was paid for housing, as defined in paragraph (b)(2)(ii)(D)(1) of this section, and \$5,000 of the fringe benefit was paid for local transportation, as defined in paragraph (b)(2)(ii)(D)(3) of this section. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5). Under A's employment contract, A was required to work on a 5-day week basis, Monday through Friday. During the last three quarters of the year, A performed services 30 days in the United States and 150 days in Country X and other foreign countries.

(ii) A determined the source of all of her compensation from Corp N pursuant to paragraphs (b)(2)(ii)(A), (B), and (D)(1) and (3) of this section. A did not assert, pursuant to paragraph (b)(2)(ii)(C)(1)(i) of this section, that, under the particular facts and circumstances, an alternative basis more properly determines the source of that compensation than the bases set forth in paragraphs (b)(2)(ii)(A), (B), and (D)(1) and (3) of this section. However, in applying the time basis set forth in paragraph (b)(2)(ii)(E) of this section, A establishes to the satisfaction of the Commissioner that the first quarter of the calendar year and the last three quarters of the calendar year are two separate, distinct, and continuous periods of time. Accordingly, \$25,000 of A's annual salary is attributable to the first quarter of the year (25 percent of \$100,000). This amount is entirely compensation that was attributable to the labor or personal services performed within the United States and is, therefore, included in gross income as income from sources within the United States. The balance of A's compensation as an employee of Corp N, \$105,000 (which includes the



\$30,000 in fringe benefits that are attributable to the location of A's principal place of work in Country X), is compensation attributable to the final three quarters of her taxable year. During those three quarters, A's periodic performance of services in the United States does not result in distinct, separate, and continuous periods of time. Of the \$75,000 paid for annual salary, \$12,500 ( $30/180 \times \$75,000$ ) is compensation that was attributable to the labor or personal services performed within the United States and \$62,500 ( $150/180 \times \$75,000$ ) is compensation that was attributable to the labor or personal services performed outside the United States. Pursuant to paragraphs (b)(2)(ii)(B) and (D)(1) and (3) of this section, A sourced the \$25,000 received for the housing fringe benefit and the \$5,000 received for the local transportation fringe benefit based on the location of her principal place of work, Country X. Accordingly, A included the \$30,000 in fringe benefits in her gross income as income from sources without the United States.

Example 4. Same facts as in Example 3. Of the 150 days during which A performed services in Country X and in other foreign countries (during the final three quarters of A's taxable year), she performed 30 days of those services in Country Y. Country Y is a

[[Page 40669]]

country designated by the Secretary of State as a place where living conditions are extremely difficult, notably unhealthy, or where excessive physical hardships exist and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. government present at that place. Corp N has a policy of paying its employees a \$65 premium per day for each day worked in countries so designated. The \$65 premium per day does not exceed the maximum amount that the U. S. government would pay its officers or employees stationed in Country Y. Because A performed services in Country Y for 30 days, she earned additional compensation of \$1,950. The \$1,950 is considered a hazardous duty or hardship pay fringe benefit and is sourced under paragraphs (b)(2)(ii)(B) and (D)(5) of this section based on the location of the hazardous or hardship duty zone, Country Y. Accordingly, A included the amount of the hazardous duty or hardship pay fringe benefit (\$1,950) in her gross income as income from sources without the United States.

Example 5. (i) During 2006 and 2007, Corp P, a domestic corporation, employed four United States citizens, E, F, G, and H to work in its manufacturing plant in Country V. As part of his or her compensation package, each employee arranged for local

transportation unrelated to Corp P's business needs. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5) and (f).

(ii) Under the terms of the compensation package that E negotiated with Corp P, Corp P permitted E to use an automobile owned by Corp P. In addition, Corp P agreed to reimburse E for all expenses incurred by E in maintaining and operating the automobile, including gas and parking. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, E's compensation with respect to the fair rental value of the automobile and reimbursement for the expenses E incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on E's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in E's gross income as income from sources without the United States.

(iii) Under the terms of the compensation package that F negotiated with Corp P, Corp P let F use an automobile owned by Corp P. However, Corp P did not agree to reimburse F for any expenses incurred by F in maintaining and operating the automobile. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, F's compensation with respect to the fair rental value of the automobile is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on F's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in F's gross income as income from sources without the United States.

(iv) Under the terms of the compensation package that G negotiated with Corp P, Corp P agreed to reimburse G for the purchase price of an automobile that G purchased in Country V. Corp P did not agree to reimburse G for any expenses incurred by G in maintaining and operating the automobile. Because the cost to purchase an automobile is not a local transportation fringe benefit as defined in paragraph (b)(2)(ii)(D)(3) of this section, the source of the compensation to G will be determined pursuant to paragraph (b)(2)(ii)(A) or (C) of this section.

(v) Under the terms of the compensation package that H negotiated with Corp P, Corp P agreed to reimburse H for the expenses that H incurred in maintaining and operating an automobile, including gas and parking, which H purchased in Country V. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(3) of this section, H's compensation with respect to the reimbursement for the expenses H incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(3) of this section based on

H's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in H's gross income as income from sources without the United States.

Example 6. (i) On January 1, 2006, Company Q compensates employee J with a grant of options to which section 421 does not apply that do not have a readily ascertainable fair market value when granted. The stock options permit J to purchase 100 shares of Company Q stock for \$5 per share. The stock options do not become exercisable unless and until J performs services for Company Q (or a related company) for 5 years. J works for Company Q for the 5 years required by the stock option grant. In years 2006-08, J performs all of his services for Company Q within the United States. In 2009, J performs  $\frac{1}{2}$  of his services for Company Q within the United States and  $\frac{1}{2}$  of his services for Company Q without the United States. In year 2010, J performs his services entirely without the United States. On December 31, 2012, J exercises the options when the stock is worth \$10 per share. J recognizes \$500 in taxable compensation  $((\$10-\$5) \times 100)$  in 2012.

(ii) Under the facts and circumstances, the applicable period is the 5-year period between the date of grant (January 1, 2006) and the date the stock options become exercisable (December 31, 2010). On the date the stock options become exercisable, J performs all services necessary to obtain the compensation from Company Q. Accordingly, the services performed after the date the stock options become exercisable are not taken into account in sourcing the compensation from the stock options. Therefore, pursuant to paragraph (b)(2)(ii)(A), since J performs  $3\frac{1}{2}$  years of services for Company Q within the United States and  $1\frac{1}{2}$  years of services for Company Q without the United States during the 5-year period,  $\frac{7}{10}$  of the \$500 of compensation (or \$350) recognized in 2012 is income from sources within the United States and the remaining  $\frac{3}{10}$  of the compensation (or \$150) is income from sources without the United States.

\* \* \* \* \*

(d) Effective date. \* \* \* Paragraph (b) and the first sentence of paragraph (a)(1) of this section apply to taxable years beginning on or after July 14, 2005.

PART 602--OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

0

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

0

Par. 4. In Sec. 602.101, paragraph (b) is amended by adding an entry for Sec. 1.861-4 in numerical order to the table to read as follows:

Sec. 602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

CFR part or section where Identified and described	Current OMB control No.
1.861-4.....	<b>1545-1900</b>

Mark E. Matthews,  
Deputy Commissioner for Services and Enforcement.

Approved: July 5, 2005.

Eric Solomon,  
Acting Deputy Assistant Secretary for Tax Policy.

[FR Doc. 05-13681 Filed 7-13-05; 8:45 am]

BILLING CODE 4830-01-P