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INTERNAL REVENUE SERVICE
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MEMORANDUM FOR

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations) (by Jerry E. Holmes)

SUBJECT: Income Tax Withholding on Compensation Paid to Nonresident Alien

This memorandum relates to the issue of whether the "included-excluded" rule of section 3402(e) of the Code applies to remuneration paid to nonresident aliens who perform a portion of their services within the United States and the remainder of their services outside the United States. This memorandum replaces a prior field service advice that was issued and withdrawn.

INTRODUCTION

Under the included-excluded rule of section 3402(e), if remuneration paid by an employer to an employee for services performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, then all the remuneration paid by such employer to such employee for such period is deemed to be wages. Conversely, if the remuneration paid by an employer to an employee for services performed during more than one-half of any such payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period is deemed to be wages. If nonresident aliens perform less than half of their services in the United States, the practical effect of applying section 3402(e) is that withholding on remuneration for services performed within the United States by the nonresident aliens would be under section 1441 rather than section 3402.

For purposes of this memorandum, we assume that the compensation of the nonresident aliens is not exempt from United States federal income tax or employment tax withholding under an income tax convention or a social security totalization agreement.

ISSUE

Whether section 3402(e) applies when a nonresident alien employee performs a portion of his or her services as an employee within the United States and the remainder of the services outside the United States.

CONCLUSION

Section 3402(e) is inapplicable when a nonresident alien employee performs a portion of his or her services as an employee within the United States and the remainder of the services outside the United States.

BROAD OVERVIEW

Income Tax Withholding

Section 3402(a) provides for withholding on wages paid by employers. The amount of withholding is determined pursuant to tables in Publication 15, Circular E, Employer's Tax Guide. These tables and withholding under section 3402 are generally designed to provide for withholding commensurate with the employee's liability for federal income tax under section 1. Withholding under section 3402 is reported on Form 941, Employer's Quarterly Federal Tax Return, and the employee is provided with a Form W-2, Wage and Tax Statement.

Section 1441 generally provides for a 30 percent withholding tax on United States source compensation paid to nonresident aliens. Withholding under section 1441 is not required on a payment if the payment is subject to withholding under section 3402. Section 1441 withholding is reported by the withholding agent on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and the recipient of the income receives from the withholding agent Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding.

DISCUSSION

Law and Regulations.

1. Wage Withholding under section 3402

As noted above, section 3402(a) requires every employer making payment of wages to deduct and withhold a tax determined in accordance with tables or computational procedures prescribed by the Secretary.

Section 3401(a) defines "wages" as all remuneration for employment, with certain specific exceptions. Section 31.3401(a)-2(a)(1) of the Employment Tax Regulations provides that the term "wages" does not include any remuneration for services performed by an employee for his or her employer which is specifically excepted from wages under section 3401(a).

Section 3401(a)(6) provides an exception from the definition of wages for such services performed by a nonresident alien individual as may be designated by regulations prescribed by the Secretary.

Section 31.3401(a)(6)-1(a) of the regulations provides that all remuneration paid after December 31, 1966, for services performed by a nonresident alien individual, that would otherwise constitute wages within the meaning of § 31.3401(a)-1 and that is effectively connected with the conduct of a trade or business within the United States, is subject to withholding under section 3402 unless otherwise excepted from wages under this section. Two specific exceptions are provided. First, section 31.3401(a)(6)-1(b) of the regulations provides that remuneration paid to a nonresident alien individual (other than a resident of Puerto Rico) for services performed outside the United States is excepted from wages and hence is not subject to withholding. Second, section 31.3401(a)(6)-1(e) provides that remuneration paid for services performed within the United States by a nonresident alien individual is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from the income tax imposed by chapter 1 of the Code by reason of a provision of the Internal Revenue Code or an income tax convention to which the United States is a party.

Section 3402(e) contains the included-excluded rule that is the focus of this memorandum. As noted, it provides that if the remuneration paid by an employer to an employee for service performed during one-half or more of any payroll period of not more than 31 consecutive days constitutes wages, all the remuneration paid by the employer to the employee for the period is deemed to be wages; but if the remuneration paid by the employer to the employee for services performed during more than one-half of the payroll period does not constitute wages, then none of

the remuneration paid by such employer to such employee for such period is deemed to be wages.

Section 31.3402(e)-1(a) of the regulations provides that for purposes of the included-excluded rule, the relative amounts of time spent performing services that generate section 3401(a) wages and non-section 3401(a) remuneration determine whether all the remuneration for services performed during the payroll period is treated as "included" or "excluded." Section 31.3402(e)-1(b) of the regulations provides that if one half or more of the employee's time in the employ of a particular employer in a payroll period is spent performing services the remuneration for which constitutes wages, then all the remuneration paid the employee for services performed in that payroll period is deemed to be wages. Conversely, section 31.3402(e)-1(c) of the regulations provides that if less than one half of the employee's time in the employ of a particular employer in a payroll period is spent performing services the remuneration for which constitutes wages, then none of the remuneration paid the employee for services performed in that payroll period is deemed to be wages.

The regulation contains two examples, neither of which involves amounts excepted from wages under section 3401(a)(6).

> Example 1 of section 31.3402(e)-1(d) of the regulations concerns an employer who operates a store and a farm and hires an employee to perform services in connection with both enterprises. The regulations state that the remuneration paid for services on the farm is excepted as remuneration for agricultural labor,[1] and the remuneration for services performed in the store constitutes wages. The employee is paid on a monthly basis. During each month the employee performs some services for the farm and some for the store. The example illustrates that, because of the included-excluded rule, the determination of whether the total remuneration is subject to income tax withholding depends upon whether the employee's hours of service for the store during the payroll period are equal to or greater than the hours of service for the farm during the payroll period.
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> Example 2 of section 31.3402(e)-1(d) contains another fact situation illustrating the included-excluded rule. Under this example, the employee performs services in the same payroll period for the same employing individual in the office and domestic service in the employer's private home.

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[1] Under section 3401(a)(2) at the time the regulation was promulgated, remuneration for agricultural labor was excepted from wages. Under current section 3401(a)(2), remuneration for agricultural labor is excepted unless the remuneration for such labor is FICA wages as defined in section 3121(a).

> The remuneration for services in the home is excepted from the definition of wages by section 3401(a)(3) and the remuneration for services in the office constitutes wages. The example again provides that the application of the included-excluded rule depends on the relative hours of service performed in each type of employment in the payroll period.

2. Section 1441 Regulations

Section 1.1441-4(b)(1) requires 30 percent withholding tax on amounts paid to nonresident aliens as U.S. source effectively connected compensation, unless that compensation is subject to withholding under section 3402, or would be subject to withholding under section 3402 but for the provisions of section 3401(a) (other than the exception for 3401(a)(6)). Section 1.1441-4(b)(3) allows a nonresident alien who has United States source effectively connected compensation and is subject to section 1441 withholding to enter into a withholding agreement with the Office of the Assistant Commissioner (International) to reduce his/her withholding amount to reflect the personal exemption and the graduated rate of tax under section 1.

The new regulations under section 1441 provide another option for the nonresident alien, if that person's United States source effectively connected compensation is exempt from withholding under section 3402 because of the included/excluded rule of section 3402(e). Section 1.1441-4(b)(1). In that case the employer and employee may enter into a withholding agreement under section 3402(p). Consequently, the employer is relieved from withholding under section 1441 and instead withholds under the wage withholding tables that apply for purposes of section 3402. The new 1441 regulations are not yet in effect.

FICA Rule -- Rev. Rul. 79-318 and Inter-City Truck Lines

FICA tax is imposed on wages, which is defined in section 3121(a) as all remuneration for employment unless specifically excepted.

Section 3121(b) defines "employment" for FICA purposes as any service, of whatever nature, performed:

> (A) by an employee for the person employing him, irrespective of the citizenship or residence of either
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> (i) within the United States, or
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> (ii) on or in connection with an American vessel or American aircraft under a contract of service which is entered into within the United States or during the performance of which and while the employee is employed on the vessel or aircraft it touches at a port in the United States, if the employee is employed on and in connection with such vessel or aircraft when outside the United States, or

(B) outside the United States by a citizen or resident of the United States as an employee for an American employer, or

(C) if it is service which is designated as employment pursuant to a totalization agreement entered into under section 233 of the Social Security Act.

Thus, if a nonresident alien employee performs services in connection with an American vessel or American aircraft under a contract of service which is entered into within the United States, the employee's services are subject to FICA taxes regardless of whether the services are performed within or without the United States .[2] Thus, FICA taxes would apply to all the remuneration received by such employees.

If section 3121(b) imposes FICA taxes on all remuneration for services of a nonresident alien, the included-excluded rule would not apply. However, it is important to note that the FICA has an included-excluded rule in section 3121(c) that is similar to the rule for income tax withholding purposes. Section 3121(c) provides that if the services performed during one half or more of any pay period by an employee constitute employment, all of the services performed during such period shall be deemed to be employment; but if the services performed during more than one half of a pay period by an employee do not constitute employment, then none of the services shall be deemed to be employment.

In Rev. Rul. 79-318, 1979-2 C.B. 352, the Service considered the application of the included-excluded rule of the FICA to services performed within the United States by Canadian citizen employees working for a Canadian employer. Under the facts of the ruling, in every pay period each employee performed services for less than one-half of the pay period within the United States. The ruling concludes that the included-excluded rule found in section 3121(c) does not apply to this situation. The ruling states that the included-excluded rule in section 3121(c) applies only to services that are performed within the United States or services that are performed without the United States by a United States citizen for an American employer and that the specific exceptions provided in section 3121(b) are used to determine whether amounts are included or excluded.

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[2] Section 3121(b)(4) provides an exception from employment for services performed by an individual on or in connection with a vessel not an American vessel or on or in connection with an aircraft not an American aircraft, if (A) the individual is employed on and in connection with such vessel or aircraft, when outside the United States and (B)(i) such individual is not a citizen of the United States or (ii) the employer is not an American employer. This exception is not applicable if the vessel is an American vessel or if the aircraft is an American aircraft.

Rev. Rul. 79-318 cites and is based on the facts of Inter-City Truck Lines, Ltd. v. United States, 408 F.2d 686 (Ct. Cl. 1969). The court in that case rejected a literal reading of section 3121(c), which seemingly supported the plaintiff's position. The court examined the legislative history and the "contemporaneous construction" of the provision by the Service.[3] 406 F.2d at 687-688. The court held that the included-excluded rule applies only where the employee is performing both (1) services that fall within the basic definition of employment contained in section 3121(b), and (2) other services that fall within the basic definition of employment contained in section 3121(b) but are excluded by one of the specific enumerated exceptions.

Although Rev. Rul. 79-318 and Inter-City Truck Lines provide direct authority for the interpretation of the FICA and FUTA included-excluded rules, the wording of the income tax withholding included-excluded rule and the structure of the provisions defining wages under the income tax withholding provisions raise the issue of whether the result should be different under the income tax withholding provisions. In both the FICA and the FUTA, wages is defined as remuneration for employment and a separate subsection exists concerning the definition of "employment." No such definition of "employment" exists for income tax withholding purposes. Further, the FICA and FUTA included-excluded rule relates to "employment" whereas the income tax withholding rule relates to "wages." Despite these distinctions, there is authority for interpreting the income tax withholding rule in the same manner as the FICA and FUTA for this purpose.

Legislative History

The income tax withholding provisions had their origin in the Revenue Act of 1942, 56 Stat. 884. Many of the income tax withholding exceptions were designed to be

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[3] The "contemporaneous construction" referred to by the court was contained in S.S.T. 402, 1940-2 C.B. 252. The ruling stated as follows, at 1940-2 C.B. 253:

> In the opinion of the Bureau, section 1426(c) and section 1607(d), supra, were not intended to include as "employment" services performed outside the United States or to exclude from "employment" services performed within the United States on the basis of the relations in quantity of services performed within the United States to the entire services performed both within and without the United States.

The references to section 1426(c) and section 1607(d) are to the predecessors of section 3121(c) and section 3306(d). (Section 3306(d) contains the Federal Unemployment Tax Act (FUTA) included-excluded rule.)

similar to the FICA and FUTA tax exceptions. Senate Rep. No. 1631, 77th Cong., 2d Sess., 166 (1942) stated as follows with respect to some exceptions from wages in the original income tax withholding provisions:

> These exceptions are identical with the exceptions extended to such services for Social Security tax purposes and are intended to receive the same construction and have the same scope.

The 1942 Act also provided an additional exception from the definition of wages for "services performed as an employee while outside the United States ..., unless the major part of the services performed during the calendar year by such employee for such employer are performed within the United States." See section 465(b)(7) of 1942 Act. The committee reports state that "[t]he exception does not extend to wages paid an employee whose services are performed partly within and partly without the United States if the major portion of such employee's services during the year are performed within the United States." Sen. Rep. No. 1631 at page 167.

The 1942 Act also added the included-excluded rule for income tax withholding purposes with similar wording to the current section 3402(e). The legislative history states that:

> In order to avoid administrative difficulties, section 426(h) provides that if the remuneration paid for services performed during one-half or more of any pay-roll period constitutes wages, all the remuneration paid for such period shall be deemed to be wages; but if the remuneration paid for services performed during more than one-half of such pay-roll period does not constitute wages, then none of the remuneration paid for such period shall be deemed to be wages. The rule prescribed is similar to that adopted for social security tax purposes.

H.R. Rep. No. 2333, 77th Cong., 2d Sess., 127 (1942); Sen. Rep. No. 1631, 77th Cong., 2d Sess. 167 (1942).

A similar desire for ease of administration by having similar exceptions for purposes of the FICA, the FUTA, and federal income tax withholding was also evidenced in the legislative history of the Current Tax Payments Act of 1943, which enacted income tax withholding provisions that replaced the Revenue Act of 1942 provisions. See S. Rep. No. 221, 78th Cong., 1st Sess., 17 (1943); H.R. Rep. No. 510, 78th Cong., 1st Sess., 28 (1943). The 1943 Act changed the included-excluded rule by limiting its application to payroll periods of not more than 31 consecutive days. H.R. Rep. No. 510 at 38. The 1943 Act also provides an exception from the definition of wages remuneration paid for "services performed by a nonresident alien individual, other than a resident of a contiguous country who

enters and leaves the United States at frequent intervals." See section 2(a) of 1943 Act.

In 1966, Congress changed the taxation of remuneration for services performed by nonresident aliens. See Public Law No. 89-809, 89th Cong., 2d Sess. (1963). Formerly, the services of nonresident aliens within the United States had been subject to withholding only under section 1441. Section 3401(a)(6), as presently worded, was added to the Code by section 103(k) of Pub. L. 89-809 to provide for an exception from wages for such services as may be designated by regulations prescribed by the Secretary or his delegate. The legislative history is illuminating as to the concern of Congress in making the 1966 change:

> Your committee believes that withholding at the 30-percent rate should only be required in the case of income which is taxed at that rate. Therefore, income which is effectively connected to the conduct of a U.S. trade or business should not be subject to this withholding tax at a 30-percent rate. This is particularly important in the case of compensation paid a nonresident alien....[S]ince the regular graduated rates on small incomes are less than 30 percent, this rate may result in substantial overwithholding in many cases where regular income tax rates apply. Although an alien may obtain a refund of the excess withholding when he files his return at the end of the year, overwithholding in these circumstances can create a substantial hardship for the alien.

H. R. Report No. 1450, 89th Cong.,2d Sess., 1, 24 (1966). See also Sen. Rep. No. 1707, 89th Cong., 2d Sess. 1, 30.

RATIONALE FOR NOT APPLYING THE INCLUDED-EXCLUDED RULE

1. Application of the included-excluded rule would frustrate the effect of the regulations under section 31.3401(a)(6)-1, by overriding the result in the regulations.

It would frustrate the intent of section 31.3401(a)(6)-1 of the regulations if the included-excluded rule were applied in this context. Section 3401(a)(6) provides an exception from wages only for such services performed by nonresident aliens as may be designated by regulations prescribed by the Secretary. The language at the beginning of section 31.3401(a)(6)-1 of the regulations, which were published in 1966 and subsequently amended, indicates that the regulations are intended to include within the definition of wages only that remuneration that is for services that are effectively connected with the conduct of a trade or business within the United States. Services performed outside the United States are, in many cases, not effectively connected with the conduct of a trade or business within the United States. Applying the included-excluded rule would, however, also exclude remuneration for services within the United States (i.e., effectively connected income) if less than 50 percent of the remuneration was for services performed within the United States. Thus, applying the included-excluded rule in the current context would unreasonably expand the exception from wages provided under section 3401(a)(6) for services performed by nonresident aliens beyond the scope of what was intended by the regulations.

2. A conclusion that the included-excluded rule of section 3402(e) does not apply in this situation is consistent with revenue rulings and case law applying the similar FICA rule.

In determining whether the income tax withholding included-excluded rule is applicable, it is necessary to consider relevant authority under the FICA dealing with the included-excluded rule. The authority under the FICA indicates that the included-excluded rule does not apply to section 3401(a)(6) type wages. Rev. Rul. 79-318 and the Inter-City Truck Lines hold that the FICA included-excluded rule does not apply in the situation where a nonresident alien employee is performing services within and outside the United States.

Consistency in interpretation between the FICA and the income tax withholding provisions is suggested in the legislative history of the 1942 Act and promotes simplicity and ease of administration. In most case, under this interpretation, a nonresident alien performing some services within the United States and other services outside the United States would generally be treated similarly for FICA and income tax withholding.

3. Under this conclusion, only amounts that are subject to United States income tax are wages for federal income tax withholding purposes.

If the included-excluded rule is applied, all remuneration, including remuneration for services performed outside the United States, is treated as wages for income tax withholding purposes. However, generally, nonresident aliens are not subject to United States income tax on remuneration from services performed outside the United States. Thus, if the included-excluded rule is applied and the employee had just over 50 percent of remuneration during a payroll period from services performed in the United States, withholding would nonetheless apply to 100 percent of the payment of remuneration.[4] This discrepancy caused by the application of the rule in this context is entirely different from the ordinary application of the rule of administrative convenience under section 3402(e). In the examples under the section 3402(e) regulations, the amounts received by the employees (whether remuneration for services included in or excluded from wages) are in either event included in gross income.

Adopting an approach that aligns income tax withholding with amounts included in gross income is consistent with the Service approach to employer-provided accident and health insurance, which is excluded from gross income under section 106. Rev. Rul. 56-632, 1956-2 C.B. 101, states that the value of the insurance coverage is not included in wages for income tax withholding purposes, even though such amounts are undoubtedly remuneration for employment and no specific exception from the definition of wages applies.

Further, because the application of the included-excluded rule in this context is based on the assumption that the basic definition of wages includes amounts that are not included in gross income, its application is counter to the general concept that amounts that are not subject to federal income tax are not includible in the definition of wages. See Rowan Cos., Inc. v. United States, 452 U.S. 247, 254 (1981). In Rowan, the Court stated that “wages” is a narrower concept that “income....” 452 U.S. at 254.[5]

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[4] However, because the included-excluded rule is applied on a payroll period basis, an employee who performed just over the 50 percent in the United States in one payroll period, may be just under 50 percent in the next period. In addition, withholding on the entire amount could be justified because an individual who is performing services within the United States for the majority of time for payroll period after payroll period could lose his or her nonresident alien status based on the substantial presence test.

[5] The Rowan case overturned a longstanding tax regulation subjecting certain meals and lodging that were excludable from gross income to FICA tax. The Court held

At least three circuits have indicated that, generally, amounts not includible in income do not fall within the basic definition of FICA wages. Anderson v. United States, 929 F.2d 648 (Fed. Cir. 1991); Dotson v. United States, 87 F.3d 682 (5th Cir. 1996); and Gerbec v. United States, 164 F.3d 1015 (6th Cir.1999) . Although the Service does not agree that amounts excluded from income are necessarily excluded from FICA wages, these cases are appellate decisions.[6] If these cases were interpreted to apply to the definition of wages for federal income tax withholding purposes, the payments to the nonresident aliens for services performed outside the United States would not be included in the basic definition of wages and there would be a direct analogy to Inter-City Truck Lines.

An argument that amounts that are excludable from gross income are subject to federal income tax withholding purposes is legally even less compelling than an argument that amounts that are excludable from gross income are subject to FICA tax.[7] FICA tax is based on the objectives of the social security system, which can differ from those of the income tax withholding system. The income tax withholding

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that the definitions of wages under the FICA and the FUTA and the definition of wages for income tax withholding purposes should be interpreted in tax regulations in the same manner in the absence of statutory provisions to the contrary.

[6] The Service's position is that, after the Social Security Amendments of 1983, 1983-2 C.B. 309, amounts that are not subject to federal income tax can nevertheless be subject to FICA tax. See section 3121(v), for example. If the services of the nonresident alien worker are specifically included in the definition of employment for FICA tax purposes under section 3121(b), there are strong reasons to hold that remuneration of the worker, even if excluded from gross income, should be subject to FICA tax, given the policy reasons for such a coverage provision.

[7] In the Social Security Amendments of 1983, Pub. L. No. 98-21, Congress attempted to override the broad rationale of the Rowan decision, while incorporating the narrow holding of the case that amounts excludable under section 119 are not subject to FICA taxes. The "anti-Rowan amendment" is found in the penultimate sentence of section 3121(a). The committee reports in connection with this amendment state as follows:

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

S. Rep. No. 98-23, 98th Cong., 1st Sess., p. 42 (1983).

provisions are designed to provide for income tax withholding equivalent to income tax liability. See Notice 92-6, 1992-1 C.B. 495. Treating amounts that are excludable from gross income as falling within the basic definition of wages for federal income tax withholding purposes makes little sense in light of the purpose of section 3402 withholding.

(4) This conclusion is consistent with Congressional intent that income of nonresident aliens that is subject to taxation at the graduated income tax rates should be subject to the graduated income tax withholding tables.

The discussion of the legislative history in connection with the 1966 legislative changes indicates that one of Congress' principal concerns in making the change in section 3401(a)(6) to allow income tax withholding under section 3402 to apply to wages of nonresident aliens was to have the graduated income tax withholding of section 3402 apply to income of the nonresident alien that is subject to graduated income tax under section 1. Application of the included-excluded rule frustrates this Congressional intent by subjecting income that is subject to graduated income tax under section 1 to 30 percent withholding under section 1441.

(5) This conclusion avoids overwithholding.

Consideration of the scope of the included-excluded rule must also acknowledge the practical effect of applying the rule to a nonresident alien performing only a portion of his or her services in the United States. As noted in Notice 92-6, 1992-1 C.B. 495, "[t]he principal purpose of wage withholding is to assure current payment of the correct amount of Federal income taxes." The federal income tax withholding regime under section 3402 is designed to have the withholding approximate the income tax liability of the recipient. Thus, in 1992, income tax withholding tables were revised because the previous tables were resulting in "substantial overwithholding" (i.e., the amounts withheld were substantially in excess of the income tax liabilities of the recipients). See Notice 92-6.

Absent a withholding agreement under section 1441, as described earlier, it is generally agreed that applying the included-excluded rule of section 3402(e) in a situation in which a nonresident alien performs only a small portion of his services within the United States, together with section 1441, will produce overwithholding. Withholding on nonresident aliens who perform less than 50 percent of their services in the United States will be at a 30 percent rate which will usually result in overwithholding. Also in the case of nonresident aliens who perform a significant part of their services outside of the United States, but who perform 50 percent or more of their services within the United States, withholding under section 3402(a) on the entire amount of their remuneration will result in overwithholding, because the remuneration for services outside the United States will generally be exempt from United States income tax. We do not believe that this overwithholding was

what Congress intended with the passage of the included-excluded rule. In contrast, our conclusion that the rule does not apply in this situation results in graduated withholding on the nonresident alien's remuneration for services within the United States that will better correlate with the portion of his or her income tax liability that is computed under the graduated income tax tables under section 1.

(6) This conclusion is supported by the original rationale for the included-excluded rule: administrative simplicity. Application of the included-excluded rule to the remuneration of nonresident aliens undercuts the original rationale for the included-excluded rule.

Applying section 3402(e) in this situation would also undercut the original rationale for the application of the rule: creating administrative simplicity for employers. If the rule applies, an employer that had a worker who performed less than 50 percent of his or her services within the United States in some payroll periods, but 50 percent or more of his or her services outside the United States in other payroll periods, would have withholding under section 1441 in some payroll periods and withholding under section 3402 in the other payroll periods. This would require maintenance of two withholding systems, two sets of reporting to the Service, and two sets of reporting to the employee. The employer would have to include amounts paid the worker on Form 941 and Form 1042 and would be required to give the employee Form W-2 and Form 1042-S. This is directly counter to the administrative simplicity that was the rationale for the rule in the first place. Under this position, only one set of returns would be required to be filed, and all amounts includible in income would be reported on Form W-2.

We also note that in any case where any part of the remuneration of the nonresident alien is subject to FICA tax, the FICA wages and FICA tax withheld would have to be reported on Form 941 and Form W-2. In the case of nonresident aliens performing certain transportation services, all services are treated as within the definition of FICA employment. See section 3121(b). Also, in a fact situation such as Rev. Rul. 79-318, where the included-excluded rule is not applied for purposes of FICA tax and the employee performs a portion of his or her services within the United States, the employer would have to file Form 941 and Form W-2 with respect to the FICA wages paid to the employee. Thus application of the included-excluded rule for income tax withholding purposes would necessitate filing two sets of returns in virtually every case where less than half of the services were performed in the United States. In contrast, under the position of this memorandum, the employee's remuneration subject to FICA taxation, the remuneration subject to United States income taxation, and the income tax withholding would simply be reported on Form W-2 and Form 941.

Thus, the original rationale of the included-excluded rule strongly supports our conclusion.

(7) Summary

The argument has been made that the statute is clear on its face, and section 3402(e) should apply under the literal language of the statute. However, the withholding statute should not be applied without consideration of the legislative history and case law in the withholding area.

Consideration of Inter-City Truck Lines, Rev. Rul. 79-318, the legislative history of section 3402(e), the purposes of wage withholding, the income tax withholding regulations, and the overwithholding potentially produced by application of the rule in this context provide strong support for not applying section 3402(e) to nonresident aliens who perform a portion of their services within the United States. Thus, we conclude that section 3402(e) does not apply in this context.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

If you have any questions, contact the branch number.