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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-208254-90; REG-136481-04

RIN 1545-AO72; RIN 1545-BD62

Source of Compensation for Labor or Personal Services

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking and notice of proposed rulemaking.

SUMMARY: This document contains new proposed rules that describe the proper basis for determining the source of compensation from labor or personal services performed partly within and partly without the United States. The new proposed rules will affect individuals that earn compensation from 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. This document also withdraws the notice of proposed rulemaking (REG-208254-90) published in the **Federal Register** on January 21, 2000 (65 FR 3401).

DATES: Written or electronic comments and requests for a public hearing must be received by November 4, 2004. The notice of proposed rulemaking published on January 21, 2000, is withdrawn as of August 6, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-208254-90), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-208254-90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington DC or sent electronically, via the IRS Internet site at: www.irs.gov/regs or Federal eRulemaking Portal at www.regulations.gov (IRS and REG-208254-90).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David Bergkuist, (202) 622-3850 (not a toll-free number); concerning the submissions of comments, Lanita Van Dyke (202) 622-7180, (not a toll-free number).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224. Comments on the collection of information should be received by October 5, 2004. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in this proposed regulation are in §1.861-4(b)(2)(ii)(C)(1)(i), (b)(2)(ii)(D), and (b)(2)(ii)(D)(6). The information required in §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 §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 §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.

The collections of information and responses to these collections of information are required to obtain and maintain benefits. The likely respondents are individuals who perform labor or personal services partly within and partly without the United States, some of which may receive certain fringe benefit compensation for those services.

Estimated total annual recordkeeping burden: 10,000 hours.

The estimated annual burden per recordkeeper varies from 15 minutes to one hour, depending on the circumstances of the individual, with an estimated average of 30 minutes.

Estimated number of recordkeepers: 20,000.

An agency may not conduct or sponsor, and a person is not required to 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 may 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 proposed amendments (the new proposed regulations) 26 CFR part 1 under section 861 of the Internal Revenue Code (Code). On January 21, 2000, a notice of proposed rulemaking was published in the **Federal Register** at 65 FR 3401 [REG-208254-90; 2000-1 C.B. 577] (the previously proposed regulations). The previously proposed regulations would have modified the existing final regulations relating to the determination of the source of income from the performance of labor or

personal services performed partly within and partly without the United States. Written comments were received in response to the notice of proposed rulemaking. A public hearing was held on July 18, 2000. In response to these comments, and after further consideration of the issue, the previously proposed regulations are withdrawn and new regulations are proposed. This preamble discusses comments received on the previously proposed regulations and describes the differences between the new proposed regulations and the previously proposed regulations.

Explanation of Provisions

The existing final regulations, §1.861-4(b), provide that if a person performs labor or personal services partly within and partly without the United States, the amount to be included in gross income from United States sources shall be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

The previously proposed regulations retained the facts and circumstances basis for determining the source of such income for persons other than individuals. For individuals, however, the previously proposed regulations provided that if an individual received compensation for a specific time period for labor or personal services that are performed partly within and partly without the United States, the amount of compensation for labor or personal services performed within the United States would have been determined solely on a time basis.

Several comments questioned the rule in the previously proposed regulations that required individuals to determine the source of such income on a time basis. In response to those comments, and after further consideration of the issues presented,

the previously proposed regulations are withdrawn and new regulations are proposed that take into account the concerns raised.

Treasury 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 and personal services performed partly within and partly without the United States. Compensation provided to an employee for a specific time period is generally considered to be earned by the employee ratably over that time period. Accordingly, it is appropriate generally to source such compensation on a ratable basis. In addition, Treasury and the IRS believe that this rule will provide certainty and simplification for both taxpayers and the IRS. 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. Sourcing on a time basis may be appropriate as well for individuals other than employees who receive compensation for labor or personal services and who may be viewed as earning such compensation ratably.

Nonetheless, for entities other than individuals and for individuals who are not employees, the facts and circumstances in many cases may be such that an apportionment on a basis other than a time basis may be more appropriate. For example, a corporation could receive payments under a contract for services to be performed by numerous employees at various pay levels in a number of different geographic locations. In such a case, payroll costs under the contract for services, or

another basis besides time, may more correctly reflect the proper source of the corporation's income.

The new proposed regulations retain the facts and circumstances basis as the general rule for determining the source of compensation for labor and personal services performed partly within and partly without the United States received by persons other than individuals and by individuals who are not employees. However, the new proposed regulations provide two new 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 §1.861-4(b)(2)(ii)(A), an individual who receives compensation, other than compensation in the form of certain fringe benefits, as an employee for labor or personal services performed partly within and partly without the United States is required to source such compensation on a time basis, as defined in §1.861-4(b)(2)(ii)(E).

Under the second general basis of §1.861-4(b)(2)(ii)(B) and (D), an individual who receives compensation as an employee for labor or personal services performed partly within and partly without the United States in the form of fringe benefits, as described in §1.861-4(b)(2)(ii)(D)(1) through (6), is required to source such compensation on a geographical basis (*e.g.*, at the employee's principal place of work, as defined in section 217 and §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 §1.274-5T(c) or (h) or §1.132-5, and only if the fringe benefit meets the definition set forth in the new proposed regulations. Treasury and the IRS intend to keep the list and descriptions of identified fringe benefits current and invite comments regarding whether the identified fringe benefits are appropriately defined and whether other fringe benefits should be identified in the regulations and sourced on a specific geographic basis.

Treasury and the IRS recognize that there are circumstances in which these two general bases may not be the most appropriate basis for determining the source of an employee's compensation for labor or personal services performed partly within and partly without the United States. Accordingly, the new proposed regulations at §1.861-4(b)(2)(ii)(C)(1)(i) provide that an employee may 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. For example, when an employee's compensation is tied to the performance of specific actions rather than earned ratably over a specific time period, an alternative basis may more properly determine the source of compensation than the bases for determining source of compensation described in §1.861-4(b)(2)(ii)(A) and (B).

In order to satisfy the Commissioner, an employee 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 §1.861-4(b)(2)(ii)(A) or (B). In addition, it is anticipated that the Commissioner, by ruling or other administrative pronouncement, will issue guidance as

to what procedures an employee must follow in order to assert an alternative basis to determine the source of his or her compensation for labor or personal services performed partly within and partly without the United States. Such administrative pronouncement will likely require that an individual who has \$250,000 or more in compensation for the tax year must indicate in the manner prescribed that he or she is using an alternative basis to source his or her compensation. Such individual may be required to file a form, or retain the following in his or her records: (1) a written explanation of why the alternative basis more properly determines the source of the compensation than the basis for determining source of compensation described in §1.861-4(b) (2)(ii)(A) or (B) under the facts and circumstances, and (2) a written 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 §1.861-4(b)(2)(ii)(A) or (B).

Section 1.861-4(b)(2)(ii)(C)(1)(ii) of the new proposed regulations also provides that 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) if such compensation either (1) is not for a specific time period or (2) constitutes in substance a fringe benefit described in paragraph (b)(2)(ii)(D) notwithstanding a failure to meet any requirement of paragraph (b)(2)(ii)(D). 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).

Section 1.861-4(b)(2)(ii)(C)(2) of the new proposed regulations provides that 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). This paragraph also provides that the Commissioner 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.

Section 1.861-4(b)(2)(ii)(C)(3) of the new proposed regulations is reserved with respect to artists and athletes who are employees. It is intended that the specific rules for artists and athletes who are employees 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. Comments are invited in this connection, including on the proper definition of an artist or athlete for this purpose.

Examples illustrating these new rules with respect to compensation that an individual receives as an employee are included in §1.861-4(b)(2)(ii)(G) of the new proposed regulations.

Several of the comments to the previously proposed regulations requested specific rules for compensation arrangements that relate to services performed over a period of more than one year, such as employee stock option plans, transfers of restricted property, and other deferred compensation arrangements. The new proposed regulations provide at §1.861-4(b)(2)(ii)(F) 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. Treasury and the IRS invite taxpayers to provide comments on whether alternative bases for determining the source of such multi-year compensation are appropriate.

One comment questioned whether a day was the only time period upon which to apply the time basis of sourcing compensation. In response to this comment, the new proposed regulations provide at §1.861-4(b)(2)(ii)(E) that, although the time basis is generally determined by comparing the number of days of performance of the labor or personal services by the individual within the United States to his or her total number of days of performance of labor or personal services, use of a unit of time less than a day may be appropriate for purposes of this calculation. For example, it may be more appropriate to source compensation paid to an airline flight crewmember based on a time unit of less than a day.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of 5 U.S.C. chapter 5 does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act, 5 U.S.C. chapter 6, does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

Comments and Requests for a Public Hearing

Before the new proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be made available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of a Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking published in the **Federal Register** on January 21, 2000, (65 CFR 3401), REG-208254-90 is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

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

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

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

1. The heading for paragraph (a) is revised.
2. A sentence is added at the beginning of paragraph (a)(1).
3. Paragraph (b) is revised.
4. A sentence is added at the end of paragraph (d).

The revisions and addition read as follows:

§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 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. 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 paragraph (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 comply with the requirements set forth in any applicable administrative pronouncement issued by the Commissioner.

(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 §1.274-5T(c) or (h) or §1.132-5. For purposes of this paragraph (b)(2)(ii)(D), the term principal place of work has the same meaning that it has for purposes of section 217 and §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 §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 related expenses of the type described in section 530(b)(4)(A)(i) 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. The writing 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 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 paragraph (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 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 ½ of his services for Company Q within the United States and ½ 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 3½ years of services for Company Q within the United States and 1½ years of services for Company Q without the United States during the 5-year period, 7/10 of the \$500 of compensation (or \$350) recognized in 2012 is income from sources within the United States and the remaining 3/10 of the compensation (or \$150) is income from sources without the United States.

(d) Effective date. *** The first sentence of §1.861-4(a)(1) and §1.861-4(b) apply to taxable years beginning on or after publication of the Treasury Decision adopting these rules as final regulations in the **Federal Register**.

Deputy Commissioner for Services and Enforcement.
Mark E. Matthews