

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to:

Associate Area Counsel  
(Large Business & International)

from: M. Grace Fleeman  
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(Associate Chief Counsel (International))  
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subject: Sourcing of Credit Card Interest Payments and Fees Received from U.S. Citizens and Resident Aliens Living Outside the United States

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =  
Subsidiary 1 =  
Subsidiary 2 =  
City =  
Tax Years =  
Year 1 =  
Year 2 =

ISSUES

1. Whether credit card interest and fees received by Taxpayer from U.S. citizen and resident alien customers living outside the United States (the "Customers") are U.S. source income or foreign source income.

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2. Whether ATM fees earned by Taxpayer in connection with customer transactions made on third-party ATMs located outside the United States are U.S. source income or foreign source income.

### CONCLUSIONS

1. Pursuant to I.R.C. § 861, the sourcing of credit card interest and fees received from the Customers is controlled by the residence of each Customer, as determined under I.R.C. § 7701(b) and the related regulations.

2. ATM fees earned by Taxpayer with respect to its processing of customer transactions made on third-party ATMs located outside the United States are U.S. source income.

### FACTS

Taxpayer, a financial services firm headquartered in City, provides commercial banking and credit card services. It is the parent of Subsidiary 1 and Subsidiary 2 (the “subsidiaries”).

During Tax Years, Taxpayer, through the subsidiaries, issued credit cards to the following groups of Customers: (1) U.S. citizens living in ( “U.S. territories”); (2) U.S. citizens deployed overseas with the U.S. military; (3) U.S. citizens residing outside the United States (primarily in the ); and (4) non-U.S. citizens who were not living in the United States but may have been residents aliens within the meaning of I.R.C. § 7701(b). Approximately of the Customers were living in a U.S. territory.

During Tax Years, Taxpayer had three income streams associated with the Customers: (1) interest income on credit card balances; (2) certain fees that Taxpayer treated as giving rise to original issue discount (“OID”) income;<sup>1</sup> and (3) ATM fees from third-party ATMs located outside the United States. The ATM fees related solely to services that Taxpayer performed to process transactions made by Customers using third-party ATMs outside of the United States. Although Taxpayer earned ATM fees when Customers used Taxpayer’s credit cards outside of the United States, Taxpayer did not maintain ATMs or ATM processing facilities outside the United States.

Taxpayer initially treated the income from credit card interest and fees as U.S. source income on its returns for Tax Years. Taxpayer subsequently re-determined the source of these items of income based on each Customer’s billing address on the last day of the tax year. If a particular Customer’s address was in one of the 50 states or the District of Columbia, then Taxpayer sourced interest and fees received from that customer as U.S. source income. If a Customer’s address was not in one of the 50 states or the District of Columbia, then Taxpayer sourced interest and fees received

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<sup>1</sup> We assume for purposes of this memorandum that Taxpayer’s treatment of these fees as OID is correct.

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from that Customer as foreign source income. Taxpayer filed amended returns

## LAW AND ANALYSIS

### A. Interest and OID Income

Section 861(a)(1) of the Internal Revenue Code (the “Code”) provides that interest shall be treated as income from U.S. sources if it is “[i]nterest from the United States or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of noncorporate residents or domestic corporations.” OID income is treated as interest for purposes of the sourcing rules.<sup>2</sup> As a result, the source of OID income is also determined under the rules of section 861(a)(1).<sup>3</sup> Section 862(a) provides that “interest other than that derived from sources within the United States as provided in section 861(a)(1)” shall be treated as income from sources outside of the United States. Section 7701(a)(9) provides that when used in the Code, “the [t]erm ‘United States’ when used in a geographical sense *includes only the States and the District of Columbia* (emphasis added).” Note that section 7701(a)(9) does not include U.S. territories in the definition of “United States.” As a result, interest derived from sources within a U.S. territory is treated as income from sources outside of the United States (*i.e.*, foreign source income) under section 861.

The regulations under section 861 provide further rules for determining the source of interest. Treas. Reg. § 1.861-2(a)(1) provides, in relevant part, that “[g]ross income consisting of interest from . . . a resident of the United States on a bond, note, or other interest-bearing obligation issued, assumed or incurred by such person shall be treated as income from sources within the United States.” For purposes of Treas. Reg. § 1.861-2(a)(1), the term “resident of the United States” includes “an individual who *at the time of payment* of the interest is a resident of the United States” (emphasis added).<sup>4</sup> The regulations under section 861 do not provide any special rule for sourcing interest based on an individual payor’s citizenship. The individual’s residence determines the source of the interest payment.

#### (1) Interest paid by resident aliens (other than lawful permanent residents)

Section 7701(b) of the Code, and the regulations thereunder, provide rules for determining whether an alien individual is a resident of the United States.<sup>5</sup> Section

<sup>2</sup> Treas. Reg. § 1.861-2(a)(4).

<sup>3</sup> Id.

<sup>4</sup> Treas. Reg. § 1.861-2(a)(2)(i).

<sup>5</sup> Section 937, which prescribes residency rules for determining the tax liability of individuals and rules for sourcing income specifically to U.S. territories, does not apply in determining the applicability of the payor-residence source rule of section 861(a)(1) to the U.S. territories.

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7701(b) provides that “[f]or purposes of [the Code] (other than subtitle B) [the estate and gift tax provisions] . . . [a]n alien individual shall be treated as a resident of the United States” if the individual (1) has been admitted as a lawful permanent resident of the United States (the green card test), (2) meets the substantial presence test, or (3) is qualified to elect treatment as a resident of the United States (which requires a minimum number of days of physical presence in the United States) and has made such an election (first-year election).<sup>6</sup> Generally, interest paid by an alien individual who is treated as a resident alien under section 7701(b) at the time of the interest payment is U.S. source income, while interest paid by an alien individual who is treated as a nonresident alien under section 7701(b) at the time of payment is treated as foreign source income. As discussed below, however, this result is not appropriate for aliens who are residents under the green card test but are not living in the United States.

## (2) Interest paid by U.S. citizens

Treas. Reg. § 301.7701(b)-1(a) provides that

[u]nless the context indicates otherwise, the regulations under §§ 301.7701(b)-1 through 301.7701(b)-9 apply for purposes of determining whether a United States citizen is also a resident of the United States. (This determination may be relevant, for example, to the application of section 861(a)(1) which treats income from interest-bearing obligations of residents as income from sources within the United States.)

Thus, to determine the source of interest paid by a U.S. citizen, the U.S. citizen’s residence for purposes of section 861(a)(1) should be determined under Treas. Reg. § 301.7701(b)-1. The applicable test in the context of a U.S. citizen would be the substantial presence test. An individual is treated as a resident of the United States under the substantial presence test if he or she has been present in the United States for more than 30 days during the current year and on at least 183 days during a three-year look-back period that includes the current year.<sup>7</sup> Each day of presence in the current year is counted as a full day. Each day of presence in the first preceding year is counted as one-third of a day and each day of presence in the second preceding year is counted as one-sixth of a day.<sup>8</sup> Interest paid by a U.S. citizen who satisfies the substantial presence test at the time of the interest payment should be treated as U.S. source income, while interest paid by a U.S. citizen who does not satisfy the substantial presence test at the time of payment should be treated as foreign source income

<sup>6</sup> I.R.C. § 7701(b)(1)(A). Note that for purposes of determining whether an individual is a resident of the United States under section 7701(b), “the term United States when used in a geographical sense includes the states and the District of Columbia . . . *It does not include the possessions and territories of the United States or the air space over the United States*” (emphasis added). See Treas. Reg. § 301.7701(b)-1(c)(2)(ii).

<sup>7</sup> See Treas. Reg. § 301.7701(b)-1(c)(2).

<sup>8</sup> See id.

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### (3) Interest paid by lawful permanent residents

There is a question as to how interest should be sourced if it is paid by a lawful permanent resident who lives outside of the United States at the time of payment. The emphasis that section 861 and its related regulations place on an individual's residence, rather than the individual's legal or immigration status in a particular country or jurisdiction, suggests that sourcing of interest payments by an individual should be based on the individual's place of *physical residence*. Therefore, we believe that interest paid by lawful permanent residents should be sourced in the same manner as interest paid by U.S. citizens. By analogy to the rules for interest paid by U.S. citizens, interest paid by a lawful permanent resident who would satisfy the substantial presence test at the time of the interest payment should be treated as U.S. source income. Interest paid by a lawful permanent resident who would not satisfy the substantial presence test at the time of the interest payment should be treated as foreign source income.

### (4) Interest paid by dual resident taxpayers

Under Treas. Reg. § 301.7701(b)-7(a)(1), a dual resident taxpayer (*i.e.*, an alien individual who is considered a resident of the United States pursuant to the internal laws of the United States and also a resident of a treaty country pursuant to the treaty partner's internal laws) may elect to be treated as a nonresident alien for purposes of computing his or her U.S. income tax liability if he would be a resident of the treaty country for purposes of the treaty. In a typical case, a dual resident taxpayer would be a lawful permanent resident who is living in a treaty country. A dual resident taxpayer who elects to be treated as a nonresident alien shall, however, generally be treated as a U.S. resident for purposes of the Code other than the computation of his or her own U.S. tax liability.<sup>9</sup> Accordingly, for purposes of section 861(a)(1), a dual resident taxpayer's election to be treated as a nonresident alien should be disregarded and such taxpayer's residence for purposes of sourcing interest payments should be determined under the substantial presence test.

### (5) Interest paid by servicemembers and their spouses

With respect to an active duty member of the uniformed services ("servicemember"), the Servicemembers Civil Relief Act (the "SCRA")<sup>10</sup> provides special rules regarding such a servicemember's residence for tax purposes. Pursuant to the SCRA, a servicemember retains his or her jurisdiction of residence, which may be a state, the District of Columbia, or a U.S. territory, notwithstanding presence in or absence from a state, the District of Columbia, or a U.S. territory pursuant to military orders.<sup>11</sup> Thus, for example, a servicemember who before entering the military was an Alabama resident and now is stationed in Guam on military orders continues to be

<sup>9</sup> Treas. Reg. § 301.7701(b)-7(a)(3).

<sup>10</sup> 50 U.S.C. App. § 501 et seq.

<sup>11</sup> See 50 U.S.C. App. §§ 511(6), 571(a)(1), (g)(3).

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treated as an Alabama resident for tax purposes and so would be a resident of the United States for purposes of applying the source rules of section 861. Similarly, a servicemember from Puerto Rico who is now stationed in Maryland on military orders continues to be treated as a Puerto Rico resident for tax purposes and so *would not* be treated as a resident of the United States in applying section 861. Pursuant to the Military Spouses Residency Relief Act (the “MSRRA”),<sup>12</sup> the same rules apply beginning in 2009 to the spouse of a servicemember if the spouse is present in or absent from any state, the District of Columbia, or any U.S. territory solely to be with the servicemember, who is serving in compliance with military orders, and both spouses retain the same residence.<sup>13</sup>

#### (6) Conclusion with respect to interest and OID

Based on the foregoing, the interest and OID income that Taxpayer received from the following groups of Customers should be treated as U.S source income:

- (1) Alien individuals (other than lawful permanent residents) who are treated as residents of the United States under the substantial presence test or first-year election in section 7701(b).
- (2) U.S. citizens and lawful permanent residents who would be treated as residents of the United States under the substantial presence test in section 7701(b).
- (3) Dual resident taxpayers who make an election under Treas. Reg. § 301.7701(b)-7 to be treated as nonresident aliens but who meet the substantial presence test in section 7701(b).
- (4) Servicemembers who, under SCRA, are residents of a state or the District of Columbia but are stationed in a U.S. territory pursuant to military orders.
- (5) Beginning in 2009, spouses of servicemembers who, under the MSRRA, are residents of a state or the District of Columbia but are accompanying their servicemember spouses, who are serving pursuant to military orders, to a U.S. territory.

Interest and OID income received from other Customers generally should be treated as foreign source income.<sup>14</sup>

#### B. ATM Fees

During Tax Years, Taxpayer received fees for processing Customer withdrawals of funds made on third-party ATMs located outside the United States. The Customers’

<sup>12</sup> Pub. L. No. 111-97, 123 Stat. 3007 (2009).

<sup>13</sup> See id. at § 3.

<sup>14</sup> We do not know whether the Customers include any alien individuals who would be residents under the substantial presence tax but for the fact that their days of presence are excluded pursuant to Treas. Reg. §301.7701(b)-3. If there are such Customers, please contact us for additional advice.

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accounts were debited by the amount the Customers withdrew from the ATMs. Taxpayer has not provided any evidence to show that a Customer could withdraw funds on an account with a zero balance or that a Customer could have overdrawn his or her account through an ATM transaction. Thus, based on the available facts, there did not appear to be a credit risk associated with such transactions. Furthermore, Taxpayer did not maintain ATM processing facilities outside of the United States.

Taxpayer's activities with regard to processing these ATM transactions appear to have been solely in the nature of personal services. Thus, the fees were compensation for Taxpayer's processing of such transactions through use of its computers, software, and other equipment located in the United States. Section 861(a)(3) provides, in relevant part, that "[c]ompensation for labor or personal services performed in the United States" is treated as income from sources within the United States. Consequently, based on the facts provided, it appears that Taxpayer's income from ATM fees should be treated as U.S. source income.<sup>15</sup>

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

[REDACTED]

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<sup>15</sup> Taxpayer may also have received ATM fees from third-party ATMs located outside the United States with respect to transactions made by Taxpayer customers who are not the subject of this memorandum. Our analysis concerning the source of such ATM fees would be identical with the analysis set forth above.

[Redacted]

[Redacted]

[Redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-3880 if you have any further questions.

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