

**Office of Chief Counsel
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memorandum**

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Office of Deputy Commissioner International, LBI

from: Anne Shelburne, Senior Counsel, Branch 6
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subject:

This non-taxpayer specific Chief Counsel Advice responds to your request for assistance in determining the character and source of certain payments made to foreign distributors by a multi-level marketing company (Taxpayer) and the withholding tax responsibilities of such Taxpayer. This advice may not be used or cited as precedent.

ISSUES

1. What is the character and source of payments made by Taxpayer to a nonresident alien individual distributor or foreign corporate distributor (collectively, foreign distributor) to reward the foreign distributor for cultivating a multi-level chain of distributors that result in sales of Taxpayer's products?¹
2. Under what circumstances is Taxpayer required to withhold tax under section 1441² when it pays Earnings to a foreign distributor?
3. If Taxpayer is required to withhold tax when it pays Earnings to a foreign distributor, can that requirement be modified by an income tax treaty?

¹ These payments are typically calculated on the basis of a percentage of the purchases made by distributors below the distributor earning the payment. Such payments are hereinafter referred to as "Earnings."

² Unless otherwise specified, references herein to "section" or "the Code" are to the Internal Revenue Code of 1986, as amended.

CONCLUSIONS

1. Earnings of a foreign distributor based on purchases of Taxpayer products by lower-tier distributors in the foreign distributor's sponsorship chain constitute income from performance of personal services by the foreign distributor. The source of Earnings derived from performance of personal services is based on where the services of the foreign distributor are performed subject to limited exceptions not relevant here, such that income attributable to services performed in the United States is U.S. source income.
2. Taxpayer is required to withhold tax on Earnings of a nonresident alien individual that constitute compensation for the performance of services within the United States. Taxpayer is required to withhold tax on Earnings of a foreign corporation that constitute compensation for the performance of services within the United States unless the foreign corporation provides Taxpayer with a completed Form W-8ECI.
3. If the foreign distributor is a resident of a foreign country that has an income tax treaty in force with the United States and does not have a fixed base or permanent establishment in the United States to which Earnings are attributable, Taxpayer will not be required to withhold tax if the foreign distributor provides a completed Form 8233 or Form W-8BEN to Taxpayer prior to the payment.

FACTS

Taxpayer, a U.S. corporation, produces and sells products to U.S. and foreign distributors, with some sales income sourced within the United States, and some sales income sourced outside the United States, under applicable rules. Taxpayer sells its products to the ultimate customers through a multi-level marketing arrangement, using distributors who are treated as independent contractors for U.S. federal income tax purposes. For purposes of this advice, we assume that the distributors are not employees or agents of Taxpayer or other distributors in the multi-level marketing arrangement.

A distributor's income depends on several criteria, including the amount of products the distributor purchases from Taxpayer and resells, and the success of the distributor in sponsoring, training, and supporting other distributors ("lower-tier distributors"). These lower-tier distributors may sponsor additional distributors, creating a sponsorship chain, with all distributors in the chain potentially purchasing additional products from Taxpayer. Product sales to all distributors in the sponsorship chain are made directly by Taxpayer. The distributors may re-sell the products or keep the products for personal use. A distributor sponsors a potential lower-tier distributor, who may be a resident of the sponsor's country or of another country, by supplying that person with an application to become a distributor of Taxpayer's products. If Taxpayer accepts the applicant as a distributor, the sponsor ("higher-tier distributor") is responsible for training the lower-tier distributor on Taxpayer's products, sales and marketing plans, recruitment guidelines,

and other rules, regulations, and guidelines for distributors. The higher-tier distributor is encouraged to, among other things, assist the lower-tier distributor with setting sales and recruiting goals and is encouraged to provide support and useful tools and insights that will motivate and help the lower-tier distributor achieve sales and sponsorship goals. Some higher-tier distributors meet, email, or participate in conference calls with lower-tier distributors to motivate them to recruit, sponsor, and sell.

If the lower-tier distributor (“lower-tier distributor 1”) sponsors another distributor (“lower-tier distributor 2”), lower-tier distributor 2 becomes a part of both the lower-tier distributor 1’s sponsorship chain and the higher-tier distributor’s sponsorship chain. There is no limit on the number of lower-tier distributors who can become part of a sponsorship chain. A lower-tier distributor’s success in recruiting and sponsorship activities is an important factor in the success of its sponsor’s business.

Each distributor in the chain independently purchases products from Taxpayer and carries on its sales and recruiting activities. A lower-tier distributor is not required to follow the advice of its sponsor and does not have to follow any rules or guidelines established by the sponsor. The distributor is only required to follow the rules and guidelines set out by Taxpayer.

A distributor may earn income in two ways:

1. A distributor may buy products directly from Taxpayer and sell those products to the ultimate customers. The distributor earns the difference between the price the distributor pays for the products and the price paid by the ultimate customers to the distributor. Advice has not been requested with regard to this income.
2. In addition, a distributor may receive Earnings based on purchases of products from Taxpayer by lower-tier distributors in the distributor’s sponsorship chain.

This advice only addresses the income described in 2, above.

LAW AND ANALYSIS

Generally, under the Code, a foreign person may be subject to U.S. tax depending on the character and source of the foreign person’s income. A foreign individual is subject to U.S. tax under section 871(a)(1) at a flat rate of 30 percent on income that is not effectively connected with the conduct of a trade or business within the United States and which constitutes fixed or determinable, annual or periodical gains, profits or income (FDAP). Nonresident alien individuals with income effectively connected with the conduct of a trade or business within the United States are taxed under section 871(b) at graduated U.S. tax rates. Foreign corporations are subject to similar rules contained in sections 881(a) and 882(a). The United States requires the withholding of income taxes by the payor from certain payments made to foreign persons under sections 1441 and 1442.

1. Character of Earnings

Considering the facts presented above, the Earnings are properly characterized as compensation for performance of a foreign distributor's personal services in recruiting, training, and supporting lower-tier distributors in the foreign distributor's sponsorship chain, and not income from sales of products. This conclusion is supported by the Tax Court's decision in British Timken Ltd. v. Commissioner, 12 T.C. 880 (1949), acq., 1949-2 C.B. 1,. Although the types of services provided by the foreign distributors of Taxpayer in this case differ somewhat from those provided in British Timken, that case supports the proposition that the Earnings should not be treated as income from the sale of Taxpayer's products to lower-tier distributors in the distributor's sponsorship chain.

In British Timken, a U.K. corporation ("Timken") established a sales force by appointing distributors to handle the sales of goods of a U.S. manufacturer ("USM") in Timken's territory. Timken, through its distributors, sent consulting engineers to potential customers to induce them to incorporate the goods into product designs, maintained contact with customers, procured orders, and set prices and conditions of sale. Initially, Timken took possession of the goods and reshipped them to its customers. Eventually, it directed its lower-tier distributors and customers to place orders and receive shipments directly from USM. However, USM could not sell its goods to Timken's distributors or customers without Timken's consent, since Timken had an exclusive right to sell in those territories. Title to the goods passed in the United States, with USM collecting the sales price from either Timken's distributors or customers and passing on a percentage of the sales price to Timken.

At issue was the character and source of the payments made by USM to Timken. The court determined that Timken's income from its sales activities was not derived from the sale of personal property and, thus, rejected the place of sale as determinative of the source of Timken's income. The court said:

Although a manufacturer's profits may be the direct result of the production and sale of its products, it does not follow that such sales constitute the source of the income of many persons associated with the sales such as its salesmen, buyers, agents, and officers whose earnings are attributable to other considerations such as their sales ability or technical knowledge. This is true even though the compensation received may be measured by the amount of sales. It is the situs of the activity or property which constitutes the source of the compensation paid and not the situs of the sales by which it is measured that is of critical importance.

12 T.C. at 887.

Like the taxpayer in British Timken, in this case the higher-tier foreign distributors do not take title to or beneficial ownership of products at any point. Instead, here lower-tier distributors purchase products directly from Taxpayer, and Taxpayer pays the foreign distributors an amount determined as a percentage of the lower-tier distributor's purchases from Taxpayer. Also, as in British Timken, although the compensation is measured by the amount of product sales to lower-tier distributors, such compensation is not derived from the sale of products to the distributors. Instead, the compensation is paid for other activities associated with the sale. In this case, the activities that warrant payment of Earnings are the recruiting, training, and supporting of the lower-tier distributors in the sponsorship chain.

The conclusion that the payments made by Taxpayer to a foreign distributor are characterized as income from performance of services is also consistent with precedents holding that payment of a finder's fee is compensation for services performed. In Sinclair v Commissioner, T.C. Memo 1960-113, the Court addressed the character of a payment made by one party ("Sinclair") for arranging an opportunity for another party ("Abbott"). The court found Sinclair suggested to Abbott that she knew a man who had the production rights to a story, and that she might be able to obtain the rights for Abbott to produce the play. Sinclair successfully obtained the rights for Abbott to produce the play. The court found that Sinclair asked for some compensation in the form of a finder's fee, and ultimately found that a payment made by Abbott was a finder's fee for services rendered by Sinclair to Abbott. Thus, in Sinclair, the Tax Court ruled that a payment made for an introduction and certain information constituted a payment for services rendered. Sinclair supports the conclusion that the foreign distributors' Earnings should be characterized as services income because of the similarity of the activities generating the income; in each case they involve finding, sponsoring, and ultimately uniting buyers and sellers.

Nor is it relevant if only minimal activities are undertaken by the higher-tier distributors to sponsor the lower-tier distributors. In Malchin v Commissioner, T.C. Memo 1981-460, the Court determined that compensation paid to the taxpayer for information, which led to a merger, constituted a payment for services even where "petitioner's involvement in the merger apparently consisted merely of keeping his ears open, remembering a prior conversation, and making two telephone calls." T.C. Memo 1981-460 at 12.

Similarly, this characterization is not affected by the fact that some of the compensation may, depending on the specific circumstances, be contingent or deferred -- contingent because the amount a distributor receives in a later year will not be known in the year the services are performed, and deferred because a distributor will receive a payment in a later year based on services performed in an earlier year. Accordingly, contingent and deferred compensation retains its character as compensation for services in the year such payment is actually received. See section 864(c)(6).

2. U.S. trade or business

If, within a particular taxable year, a foreign distributor performs services within the United States, the foreign distributor is engaged in a trade or business within the United States for that year. Section 864(b). Under section 864(c)(6), the determination of whether deferred compensation is taxable to a foreign distributor, who performed services within the United States, is made as if such income were taken into account in the earlier year in which the services were performed, without regard to whether the distributor is engaged in a trade or business in the United States in the year the distributor receives the deferred compensation.

3. Source of income

A foreign distributor engaged in a U.S. trade or business is subject to U.S. tax on U.S. source income derived from performance of services. Earnings attributable to services performed by the foreign distributor within the United States are from sources within the United States, while Earnings attributable to services performed by the foreign distributor outside the United States are from sources without the United States. See sections 861(a)(3), 862(a)(3), and 863(b)(1). If services are performed both within and without the United States, the amount of compensation attributable to personal services performed within the United States or outside 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. Treas. Reg. § 1.861-4. In many cases, the facts and circumstances will be such that it will be acceptable to apportion income between U.S. and foreign sources on a time basis, with income attributable to the amount of time a taxpayer performs services in the United States sourced as U.S. source income. Treas. Reg. § 1.861-4(b)(1) and (2).

In this case, although the amount of Earnings paid to a foreign distributor is determined by product purchases made by lower-tier distributors in the foreign distributor's sponsorship chain, the Earnings may compensate the foreign distributor for services performed over a number of years. The contingent and deferred compensation, though paid in a later year, may compensate the foreign distributor for recruitment, training, and supporting services performed over a multi-year period. The regulations address the sourcing of income in multi-year compensation cases in Treas. Reg. §1.861-4(b)(2)(ii)(F). The regulations provide that the source of multi-year compensation is determined generally on a time basis, over the period to which such compensation is attributable. The regulations define multi-year compensation to mean compensation that is included in income in one taxable year but is attributable to a period that includes two or more taxable years. The determination of the period to which such compensation is attributable is based on the facts and circumstances of a particular case. Thus, in this case, if apportionment of compensation paid to a foreign distributor between U.S. and foreign sources is made on a time basis, it may require determination of the number of days the foreign distributor spent in the United States recruiting, training, or supporting lower-tier distributors. Generally, if determining on a time basis

how much of a payment to a foreign distributor is U.S. source income, the regulations indicate that such amount is the amount that bears the same relationship to the total multi-year compensation as the number of days that the services were performed in the United States to the total number of days such services were performed both within and without the United States over the multi-year period. A unit of time less than a day may be appropriate for purposes of this calculation.

Finally, in this case, the source of a foreign distributor's income turns on the location of the personal services performed by that foreign distributor. Thus, determination of the source of income in this case is based on location of the activity of the higher-tier foreign distributor in recruiting, training, and supporting the lower-tier distributors in the sponsorship chain, and not on the location of the activity of lower-tier distributors. See Miller v. Commissioner, T.C. Memo 1997-134.

4. Withholding of tax at source

Section 1441(a) generally states that any person making a payment of FDAP to a nonresident alien, to the extent such item constitutes gross income from sources within the United States, is required to withhold from such item a tax equal to 30 percent thereof, unless such rate is reduced by an applicable exception. See Treas. Reg. § 1.1441-2(a). Section 1442 contains the companion rule for payments of FDAP to foreign corporations. Income from the performance of services within the United States is FDAP that would be subject to withholding unless specifically exempted.

Treas. Reg. § 1.1441-4 provides an exception from withholding for most income that is effectively connected with a trade or business in the United States. Income from the performance of personal services in the United States generally constitutes income effectively connected with a trade or business in the United States. Earnings paid to a corporate distributor for services performed in the United States is exempt from withholding tax under this exception if the distributor provides Taxpayer with a Form W-8ECI ("Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States"), documenting its status as a foreign person.

However, this exception from withholding tax on effectively connected income generally does not extend to compensation of an individual for the performance of personal services unless that income is subject to wage withholding under section 3402 or certain other exceptions that are not applicable here. Because the distributors are not employees of Taxpayer, Earnings paid to the foreign distributors constitute income from personal services that are not payments to employees taxable under section 3402. Accordingly, the Earnings are subject to withholding under section 1441 to the extent they are paid to an individual distributor for services performed within the United States. Consequently, for Earnings paid to an individual distributor, Taxpayer must determine the portion of the payment constituting income from sources within the United States and withhold on that portion. To avoid over-withholding, Taxpayer should determine,

prior to the time of payment, the source of the income based on facts relevant to the place where the foreign distributor performed the recruiting, training, and supporting of the lower-tier distributors, the activities for which it is being compensated during the year or years in issue. This may require an allocation of time spent performing those services within and without the United States by the individual higher-tier foreign distributor, and, if multi-year compensation is at issue, may require that determination to be made over a multi-year period.

If, when Taxpayer makes a payment of the Earnings to the foreign distributor, it is unable to determine the amount that is subject to withholding because it does not have sufficient facts to determine the source of the Earnings, Taxpayer must withhold on the entire amount of the Earnings to ensure that a sufficient amount is withheld. Treas. Reg. § 1.1441-3(d)(1). Therefore, Taxpayer may be required to treat the entire payment as U.S. source income and withhold up to the maximum 30 percent rate, subject to any reduction under a treaty or the Code. See also Treas. Reg. § 1.1441-2(a) (providing that for purposes of determining amounts subject to withholding, when the source of an amount is unknown at the time of payment, the amount shall be treated as from sources within the United States). Alternately, the regulations provide procedures for a withholding agent to set aside the withholding tax in an escrow account until the sourcing determination can be made. Treas. Reg. § 1.1441-3(d)(1). No provision of the Code or regulations exempts a withholding agent from withholding on a payment simply because the source of that income cannot be determined. Thus, if Taxpayer wishes to avoid over-withholding on Earnings paid to its foreign individual distributors, it must determine the portion of the payment constituting U.S. source income prior to the time of payment.

5. Application of income tax treaties

The tax treatment of Earnings paid to a foreign distributor may be modified by an income tax treaty if the foreign distributor is a resident of a foreign country with which the United States has an income tax treaty in force.

In the case of distributors who are nonresident alien individuals, the applicable treaty provisions are those that apply to personal services income that does not arise in an employment context. In many U.S. income tax treaties currently in force, the applicable article would be the Independent Personal Services article, which generally focuses on whether a service provider who is a resident of one Contracting State is physically present in the other Contracting State for a specified number of days or has a "fixed base" available to them in that State to which the income is attributable. Some of the newer U.S. income tax treaties have eliminated the Independent Personal Services article because no practical distinction can be made between a "fixed base" (as used in the Independent Personal Services article) and a "permanent establishment" (as used in the Permanent Establishment and Business Profits articles). A permanent establishment generally is a fixed place of business, although in certain circumstances a taxpayer without a fixed place of business may nevertheless have a permanent

establishment because of the activities of a dependent agent. In these newer treaties, income from the performance of activities of an independent character generally would be taxable under the Business Profits article, but only to the extent attributable to a permanent establishment in the other Contracting State.

Nonresident alien individuals who are residents of a treaty country and do not have a fixed base or permanent establishment in the United States to which their Earnings are attributable are not subject to U.S. income tax with respect to their Earnings. The Earnings in such case will be exempt from withholding under section 1441 if the distributor provides a properly completed Form 8233 (Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual) to Taxpayer prior to payment. Treas. Reg. § 1.1441-4(b)(1)(iv) and (2).

In the case of distributors that are foreign corporations, the applicable treaty articles are the Permanent Establishment and Business Profits articles. Corporate distributors that are residents of a treaty country, satisfy any applicable Limitation on Benefits article, and do not have a permanent establishment in the United States to which their Earnings are attributable are not subject to U.S. income tax with respect to their Earnings. The Earnings will be exempt from withholding under section 1441 if the distributor provides a properly completed Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) to Taxpayer prior to payment. Treas. Reg. § 1.1441-4(b)(1)(iv) and (2).

Please call Anne Shelburne at
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