



BDO Seidman, LLP
Accountants and Consultants

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Final Regulations Issued on Sourcing of Compensation

Expatriate Tax Alert

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The Internal Revenue Service (IRS) has issued final regulations on how to determine the source of compensation for employees who work partly in the U.S. and abroad, which is important in determining how much foreign earned income exclusion and foreign tax credit relief can be applied on the U.S. return.

Background

Under pre-existing final regulations, if no accurate allocation or segregation of compensation can be made, the source should be determined on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.

In an attempt to provide clearer guidance, the IRS had issued proposed regulations on this area back in 2000. Under those rules, all compensation (including fringe benefits) was to be sourced based on time-allocation (that is, sourced according to the employee's work days). Rather than becoming final, however, those regulations were withdrawn, and new proposed regulations issued on August 6, 2004, retaining time-allocation for wages, but introducing a geographic basis for sourcing of certain listed fringe benefits

Final Regulations

The final regulations, issued on July 13, 2005, are largely similar to the proposed regulations issued in 2004. For most individuals, the rules will be effective for the 2006 taxation year. They provide two new bases for determining the proper sourcing of compensation that an individual receives as employee for services performed. The basis for sourcing under the pre-existing final regulations is retained for determining the source of compensation received by persons other than individuals (e.g. partnerships and corporations) and persons who are not employees

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The source of **wages and other non-fringe benefit compensation** is to be determined on a time basis. Employees must allocate income to the U.S. based on the proportion of their U.S. work days as compared to their total work days for which the compensation is paid.

The source of **fringe benefit compensation** is to be determined on a geographical basis (generally, on the location of the employee's principal place of work). Reg. §1.861-4(b)(2)(ii)(B) defines "fringe benefits" as amounts paid specifically for housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and moving expense reimbursement. It goes on to state that these amounts must also be reasonable and substantiated by the tax payer.

The IRS also retained the proposed provision allowing employees to use an **alternative method** of determining the source of their compensation, based on facts and circumstances. However, they included strict substantiation requirements for taxpayers wishing to use this method who earn more than \$250,000 per year. Although the forms have not yet been published, the IRS anticipates that these taxpayers will be required to attach written statements to their income tax returns that disclose:

- The specific compensation or fringe benefit for which the alternative method is being used;
- the alternative method used for each item;
- a computation to show how the allocation was determined for each item; and
- a comparison of the dollar amount of the U.S. source and non-U.S. source compensation determined under both the alternative method and the method that would have otherwise been used under the regulations.

The source of **compensation which is earned over more than one year** is determined on a time basis, based on the proportion of U.S. workdays to total workdays, for the period to which the compensation is attributable. **With regard to stock options**, the regulations make it clear that a typical nonqualified option is determined based on the work days during the time from the date of grant to when the option becomes *exercisable* by the employee (in other words, once it vests). However, the alternative method described above is available to source stock option income, provided the facts and circumstances support it.

In the final regulations, the **Commissioner specifically reserved the right to source** an employee's compensation in accordance with the alternative method, provided that the compensation is either not received for a specific time period, or is in essence a fringe benefit (even if the substantiation requirements are not met). The alternative method may only be applied if it is determined that this basis is more reasonable than the basis used by the employee.

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The IRS is continuing to reserve judgment on the issue of compensation and fringe benefits received by **artists and athletes**, and states in the preamble notes that it expects that specific rules will be issued on this issue, which will require the application of a basis that most correctly reflects the proper source of the income under the facts and circumstances of each case, consistent with current law.

How this impacts you

- Program managers should talk to their tax providers to determine what sourcing rules have been applied in the past and whether the final regulations warrant a change in sourcing policy. Assess the risk accordingly to your program.
- Program managers that have in the past taken a more conservative approach to sourcing fringe benefits by sourcing them based on work days, should consider whether they would benefit from filing amending returns.
- Cost projections and assignment budgets may need updating to factor in potential changes in the amount of tax reimbursement costs.

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