DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ASSISTANCE

MEMORANDUM FOR DAVID C. LUMBRERAS
AIR TRANSPORT INDUSTRY SPECIALIST
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FROM: M. GRACE FLEEMAN
Assistant to the Branch Chief
CC:INTL:Br1

SUBJECT: Application of United States-Japan Treaty to wages of nonresident alien flight attendants based in Japan working for domestic air carriers

This Technical Assistance responds to your memorandum dated December 2, 1997. Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

ISSUES:

Issue 1

For purposes of determining the amount that a U.S. air carrier should withhold under section 3402[1] on wages paid to a nonresident alien flight attendant in scenarios 1 and 2 below, may an examiner require the air carrier to apply the source rule of Article 6(6) of the United States-Japan income tax convention (the "Treaty" or "Japanese Treaty")[2]?

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[1] Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended ("Code").

[2] Convention Between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, March 8, 1971 (1972), 23 U.S.T. 967, 1973-1 C.B. 630.

Issue 2

For purposes of determining the amount that a U.S. air carrier should withhold on wages paid to a nonresident alien flight attendant in scenario 3 below, what facts would an examiner need to evaluate to determine which treaty controls: (1) the Japanese Treaty or (2) an income tax convention between the United States and a third country in which the flight attendant is resident?

CONCLUSIONS:

Issue 1

Article 4(2) provides that the Treaty will not be applied to increase the amount of tax imposed by a Contracting State. Because 100 percent of the wages would be treated as U.S. source under Article 6(6) of the Treaty and only a portion, at most, would be U.S. source under the Code, the flight attendants in scenarios 1 and 2 are entitled to use the more beneficial Code rules in calculating their income for U.S. tax purposes. They are not required to notify their employer that they are *not* applying the Treaty. An examiner may not require an air carrier to apply Article 6(6) of the Treaty when determining the amount of a flight attendant's wages that is subject to withholding.

Issue 2

It should not be necessary for an examiner to determine which treaty controls. For the reasons discussed under Issue 1, we think it is highly unlikely that Japanese-based flight attendants employed by a U.S. air carrier would ever elect to apply the Japanese Treaty to determine the portion of their remuneration that is subject to U.S. tax. If it would be to their benefit, Japanese-based flight attendants who are resident in a third country may be able to elect to apply an income tax convention between the United States and the third country. They would need to qualify as residents of the third country for purposes of the third-country treaty, and they would need to provide to the air carrier the necessary documentation for claiming benefits under the treaty. An examiner may determine whether a particular flight attendant is entitled to benefits under a third-country treaty, but may not require either the flight attendant or the air carrier to apply such treaty.

FACTS:

In order to provide better service to non-English speaking passengers traveling on international routes, a trend has developed whereby U.S. air carriers are employing some flight attendants who speak foreign languages. Such flight attendants are generally "based in" a foreign country on an international route, but they may or may not be citizens or residents of that country for purposes of its income tax

system.[3] For example, Japanese speaking flight attendants are based in Japan to provide better service to Japanese speaking passengers. Some of these flight attendants live in Japan, while others live in third countries and commute to their base in Japan on appointed work days. Some of the Japanese speaking flight attendants are treated as residents of Japan for purposes of the Japanese tax system.

For reasons reflected in the discussion below, we think it is highly unlikely that any of the flight attendants have elected to apply the Japanese Treaty to determine the portion of their remuneration that is subject to U.S. tax. We do not know whether any of the flight attendants have notified the air carrier that they elect to apply to their remuneration an income tax treaty between the United States and a third country.

You asked us to consider the following scenarios:

Scenario 1

A U.S. air carrier hires Japanese citizens or residents as flight attendants to work its international flights between Japan and the United States. These flight attendants do not work between Japan and other foreign destinations, and do not work on flights solely within Japan. To facilitate its business operations, the air carrier bases these flight attendants in Japan.

Scenario 2

The facts are the same as in Scenario 1, except that the flight attendants work only flights between Japan and other foreign destinations.

Scenario 3

The facts are the same as in Scenario 1, except that the flight attendants are residents of a third country that has an income tax treaty with the United States.

LAW AND ANALYSIS

The Code

[3] The airline industry uses the term “domiciled” to describe a flight attendant that is assigned to work out of a particular city. The term “domicile” can have specific meanings under the Code and the regulations thereunder, as well as under foreign law, and these meanings can vary from the industry usage. This memorandum uses the concept of “based in” a particular city or country rather than the term “domiciled” to avoid confusion.

Section 3402(a) provides that, except as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with the tables or computational procedures prescribed by the Secretary.

Section 3401(a) provides, in pertinent part, that the term "wages" means all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include remuneration paid for services performed by a nonresident alien individual, as may be designated by regulations prescribed by the Secretary.

Section 31.3401(a)(6)-1(a) of the Income Tax Regulations provides that, in general, all remuneration paid after December 31, 1966, for services performed by a nonresident alien individual, if such remuneration otherwise constitutes wages within the meaning of §31.3401(a)-1 and if such remuneration is effectively connected with a trade or business within the United States, is subject to withholding under section 3402 unless excepted from wages under this section.

Section 31.3401(a)(6)-1(b) provides that remuneration paid to a nonresident alien individual (other than a resident of Puerto Rico) for services performed outside the United States is excepted from wages and hence is not subject to withholding.

Section 871(b) provides that a nonresident alien individual engaged in a trade or business in the United States during the taxable year shall be taxable as provided in sections 1 or 55 (or, prior to December 31, 1999, as provided in section 402(a)(1)) on his taxable income that is effectively connected with the conduct of a trade or business in the United States. Subject to certain exceptions not applicable here, the performance of personal services within the United States constitutes the conduct of a trade or business in the United States. Code §864(b). Only U.S.-source remuneration received by a nonresident alien individual for the performance of personal services is treated as income that is effectively connected with the conduct of a trade of business in the United States. Code §§864(c)(3), 864(c)(4)(A).

The relevant domestic source rules are found in sections 861 through 863. Sections 861(a)(3) and 862(a)(3) provide that compensation for labor or personal services performed within the United States generally is treated as income from sources within the United States, while compensation for services performed without the United States is treated as income from sources without the United States. Section 863(b) provides that income from services performed partly within and partly without the United States is treated as derived partly from sources within and partly from sources without the United States. The amount that is treated as U.S. source is determined on the basis that most correctly reflects the proper

source of income under the particular facts and circumstances, which in many cases is an apportionment on a time basis. Treas. Reg. §1.861-4(b)(1)(i). Compensation based on actual flight time paid to an airline pilot has been allocated between U.S. and foreign sources by comparing the hours of both flight and required pre-flight services performed in the United States to the total hours of such services. Rev. Rul. 77-167, 1977-1 C.B. 239.

Section 894(a)(1) provides that the provisions of the Code must be applied to any taxpayer with due regard to any treaty obligation of the United States that applies to such taxpayer. Section 31.3401(a)(6)-1(e) of the Income Tax Regulations requires nonresident aliens who claim that their remuneration is exempt from tax by reason of a provision of an income tax convention to which the United States is a party to provide statements to their employer setting forth certain specified information.

The Treaty

Under paragraph (1) of Article 3 (Resident), a "resident of Japan" includes an individual who is resident in Japan for purposes of Japanese tax. Under paragraph (2), a "resident of the United States" includes an individual who is resident in the United States for purposes of United States tax and a United States corporation. Paragraph (3) sets forth rules for determining whether an individual who is a resident of both countries under each country's domestic law will be treated as a resident of Japan or a resident of the United States for all purposes of the Treaty (including Article 4).

We assume, for purposes of this memorandum, that none of the flight attendants who are based in Japan will be treated as residents of the United States under Article 3 of the Treaty. Therefore, the flight attendants will be treated under Article 3 as either (i) residents of Japan or (ii) residents of neither the United States nor Japan. The U.S. air carrier is a resident of the United States.

Paragraph (1) of Article 4 (Scope) provides the following general rule:

> A resident of a Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to any limitations set forth in this Convention. For this purpose, the rules set forth in Article 6 shall be applied to determine the source of income.

Paragraph (6) of Article 6 (Source of Income) provides, in relevant part, that "[i]ncome from labor or personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic shall be treated as income from sources within that Contracting State, if rendered by a member of

the regular complement of the ship or aircraft."[4] Thus, paragraph (6) of Article 6 and paragraph (1) of Article 4 together provide that, subject to any limitations elsewhere in the Treaty, residents of Japan who are members of the regular complement of an aircraft operated by a U.S. resident in international traffic may be taxed by the United States on all of the income they derive from services performed aboard the aircraft.

Paragraph (1) of Article 18 (Dependent Personal Services) provides in relevant part that, subject to an exception not applicable here, wages, salaries, and similar remuneration derived by an individual who is a resident of a Contracting State from labor or personal services performed as an employee may be taxed by the other Contracting State to the extent the remuneration is derived from sources within the other Contracting State. Because the remuneration for services performed aboard the aircraft in this case will be treated as derived from sources within the United States, paragraph (1) of Article 18 allows the United States to tax 100 percent of the remuneration.

Paragraph (4) of Article 18 provides that "remuneration derived by an individual from the performance of labor or personal services as an employee aboard ships or aircraft operated by a resident of a Contracting State in international traffic shall be exempt from tax by the other Contracting State if such individual is a member of the regular complement of the ship or aircraft." Thus, absent the "saving clause" discussed immediately below, only the United States (and not Japan) would be entitled to tax remuneration paid by a U.S. air carrier to its employees (wherever resident). Article 18(4) does not affect the right of the United States to tax such remuneration.

Paragraph (3) of Article 4 contains the so-called "saving clause": "Except to the extent provided in paragraph (4) of this article, this Convention shall not affect the taxation by a Contracting State of its residents (and, in the case of the United States, its citizens)." The benefits provided by paragraph (4) of Article 18 are not among the benefits that are exempted from the saving clause pursuant to paragraph (4) of Article 4. Accordingly, both the United States and Japan may tax the U.S. source remuneration paid by a U.S. air carrier to a person who is treated as a resident of Japan under Article 3. However, under Article 5 (Relief From Double Taxation), [5] Japan would be required to allow a foreign tax credit for the

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[4] For purposes of this memorandum, we assume the Japanese-based flight attendants are members of the regular complement of the aircraft operated by the U.S. air carrier.

[5] Paragraph (1)(b) of Article 5 (which is exempt from the saving clause) provides that Japan will allow to residents of Japan a credit against Japanese tax for an appropriate amount of U.S. tax and that the source rules set forth in Article 6 will be applied for this purpose:

U.S. tax paid by such person. For purposes of determining the foreign tax credit limitation in Japan, 100 percent of the remuneration of a crew member resident in Japan would be treated as derived from foreign sources as a result of the special source rule of Article 6(6).

In the reverse situation, the Service held in Rev. Rul. 79-28, 1979-1 C.B. 457, that compensation received by a U.S. citizen residing in Japan for services performed as a flight crew member on international flights for a Japanese airline, including the portion otherwise attributable under the Code to services performed in the United States, is treated as income from sources within Japan in computing the foreign tax credit provided in Article 5(1)(a) of the Treaty. Even though sections 861(a)(3) and 862(a)(3) of the Code would, in the absence of the Treaty, apportion the compensation between the United States and Japan for purposes of the foreign tax credit, Article 6(6) of the Treaty allocates all the income in these circumstances to Japan. Thus, for purposes of determining the foreign tax credit limitation, 100 percent of the compensation of the U.S. crew member was treated as derived from foreign sources. The ruling also concludes that the normal source of income rules provided in Section 861(a)(3) are applicable for all other purposes, such as section 911.[6]

Paragraph (2) of Article 4 (sometimes referred to as the “non-aggravation clause”) provides that the Treaty will not increase the tax burden on residents of the Contracting States:

> The provisions of this Convention shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded–

> In accordance with the provisions of the laws of Japan, as in force from time to time, regarding the allowance of a credit against Japanese tax of tax payable in any country other than Japan, Japan shall allow to a resident of Japan as a credit against Japanese tax the appropriate amount of United States tax .... For the purpose of applying the Japanese credit in relation to taxes paid to the United States, the rules set forth in Article 6 shall be applied to determine the source of income.

[6] Rev. Rul. 79-28 was amplified by Rev. Rul. 79-206, 1979-2 C.B. 280. In Rev. Rul. 79-206 the Service held that compensation received by a U.S. citizen residing in Japan for personal services performed in the United States as a flight crew member on international flights for a Japanese airline is treated as Japanese source income in computing the foreign tax credit limitation provided in section 904 of the Code. The limitation is incorporated in the formula provided in section 911(a) for individuals electing to be taxed under the law in effect before 1978. The use of the treaty sourcing rule in the computation of the foreign tax credit limitation results in the appropriate reduction for foreign taxes allocable to income included under section 911(a). (*See*, current section 911(d)(6) regarding special rules denying double benefits.)

(a) By the laws of a Contracting State in the determination of the tax imposed by that Contracting State; or

(b) By any other agreement between the Contracting States.

The Treasury Department Technical Explanation of Article 4 of the Treaty provides some clarification of its intended application to Article 6 and Article 18:

> A resident of one State may be taxed by the other State only on income from sources within that other State ..., subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 6 of the Convention are to be applied. The jurisdictional rules of the Convention parallel those set forth is section 872(a) of the Internal Revenue Code, relating to nonresident individuals...
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> The convention continues the general rule (also found in our Belgian, French, Finnish, Norwegian and Trinidad and Tobago conventions) that the Convention will not affect in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded by the laws of a State in the determination of a tax imposed by that State...This rule represents the position of the United States under all conventions to which it is a party.[7]

The Treasury Department Technical Explanation of Article 6 describes how the source rules are to be applied:

> Most of the source rules set out in this article differ in minor respects from those existing in the Internal Revenue Code. Since Article 4 (relating to general rules of taxation) provides that the Convention will not increase a person's United States tax, a taxpayer is entitled to use the more beneficial of the Code or the Convention rules in calculating his income for United States tax purposes, or in the case of a citizen or resident of the United States, his foreign tax credit....
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> While, as stated, a U.S. taxpayer can choose between the source rules of the Convention or the Code, the taxpayer cannot combine the source rules of the Convention and the Code with respect to an item of income to achieve a

[7] The Technical Explanation of Article 22 of the 1972 U.S.-Norway Treaty stated that even though the [1963] OECD Model Convention did not contain a comparable provision, this rule reflected the well-established principal that a Convention will not have the effect of increasing the tax burden on residents of the signatory countries.

> benefit greater than that he could have achieved under either the Code or the Convention.
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> It should also be noted that the source rules do not serve to extend the benefits of the Convention to persons other than resident of the two States. Because the rules are only applicable for taxing residents of either State, they are not applicable in determining the source of income of residents of other States, although the income of such other residents is of a type referred to in this article.

The United States has included non-aggravation clauses in most of its treaties and also in Article 1(2) of both the 1981 and 1996 U.S. Model Treaties.[8] In discussing a similar provision in the 1942 U.S.-Canada income tax treaty, Rev. Rul. 80-147, 1980-1 C.B. 168, states that the Service views such language to mean that the amount of tax paid by an enterprise of the foreign contracting state to the United States under a tax treaty should not result in a higher amount than would be due under the Code.[9] Rev. Rul. 84-17, 1984-1 C.B. 308, described a similar provision in the 1974 U.S.-Poland income tax treaty as follows:

> The Technical Explanation of the Convention, 1977-1 C.B. 427, states that the rule of Article 5(2)(a) reflects the principle that a convention should not increase the tax burden on residents of the Contracting States.

The non-aggravation clause of the 1975 income tax convention between the United States and the United Kingdom was applied in *Snap-On Tools v. United States*, 26 Cl. Ct. 1045 (1992), *aff'd without opinion*, 26 F.3d 137 (1994). Article 27(2) of that convention provides that "this Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowances now or hereafter accorded by the laws of either Contracting State." In concluding that the plaintiff was entitled to the benefit of former section 902(c)(1) (treating dividends paid in the first 60 days of a year as having been paid from accumulated profits of the preceding year(s)) in computing its foreign tax credit under Article 23, Judge Horn said that Article 27(2) reflects the principle that a Convention should not increase the tax burden on residents of the Contracting States. 26 Cl. Ct. at 1073.

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[8] The 1981 Model included language substantially identical to that in Article 4(2) of the Japanese Treaty. The 1996 Model is broader because it substitutes the broader word "benefits" for "exclusion, exemption deduction, credit or other allowance."

[9] See "Hearings on S. Exec. Doc. A Before a Subcommittee of the Senate Foreign Relations Committee," 80th Cong., 1st Sess. 153-154 (1947), 1 U.S. Tax Conv. 945, 1091-1092 and Treasury Department's Technical Memorandum accompanying the U.S.-Thailand proposed treaty before the Senate in1965, "Hearings on S. Exec. Doc. E Before a Subcommittee of the Senate Foreign Relations Subcommittee," 89th Cong., 1st Sess. 48-49 (1965).

Issue 1

In scenarios 1 and 2, if Article 6(6) were applied to determine whether the remuneration derived by a flight attendant from services performed as part of the regular complement of a U.S. carrier's aircraft constituted income from sources within the United States that the United States was entitled to tax pursuant to Article 18(1), 100 percent of the remuneration would be taxable by the United States. Under the Code, however, only the portion of the remuneration allocated to any services actually performed in the United States would be treated as remuneration effectively connected with a trade or business within the United States that is subject to withholding under section 3402. Thus, the application of Article 6(6) in this manner would increase the flight attendants' U.S. tax burden. This result clearly violates the principle that a convention should not increase the tax burden on residents of the Contracting States.

Because Article 4 provides that the Treaty will not increase a person's U.S. tax burden, the flight attendants in scenarios 1 and 2 are entitled to use the more beneficial Code rules in calculating their income for U.S. tax purposes. If the flight attendants were claiming benefits under the Treaty with respect to their remuneration from the U.S. air carrier, they would be required to notify the carrier. *See* Treas. Reg. §31.3401(a)(6)-1(e). However, they are not required to notify the carrier that they are *not* applying the Treaty.

We conclude that an examiner may not require a U.S. air carrier to apply Article 6(6) of the Treaty when determining the amount of a flight attendant's wages that is subject to withholding. You should note that non-application of the Treaty in this context would not prevent a flight attendant from claiming benefits under the Treaty with respect to other types of income. For example, a flight attendant who receives dividends from a U.S. corporation would normally be entitled to a reduced withholding rate under paragraph (2)(a) of Article 12 (Dividends).[10]

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[10] The Technical Explanation to Article 1 of the 1996 U.S. model income tax treaty discusses the simultaneous application of a treaty and the Code:

> It follows that under the principle of paragraph 2 [the non-aggravation clause] a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provision of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of the other Contracting State has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be

Issue 2

In scenario 3, the flight attendants are residents of a third country who are based in Japan by a U.S. air carrier. They are part of the regular complement of an aircraft operated in international traffic by such carrier. You have asked what facts an examiner should evaluate in determining which treaty controls for purposes of calculating the amount that should be deducted and withheld under section 3402: (1) the Japanese Treaty or (2) the income tax convention between the United States and the third country.

It should not be necessary for an examiner to determine which treaty controls. As discussed above, application of the Japanese Treaty to Japanese-based flight attendants employed by a U.S. air carrier would increase their U.S. tax liability. Therefore, the flight attendants would be entitled to apply the more beneficial Code rules to determine the taxable amount of their remuneration from the U.S. air carrier. An examiner may not require the air carrier to apply the Treaty when determining the amount of a flight attendant's wages that is subject to withholding.

If it would be beneficial, a flight attendant residing in a third country may elect to apply a treaty between the United States and the third country, provided that the flight attendant is a resident of the third country for purposes of such treaty.[11] The flight attendant would need to provide all necessary documentation to the air carrier for claiming benefits under the treaty. A flight attendant may find it beneficial to elect to apply a third-country treaty if such treaty provides that remuneration derived by a resident of a Contracting State with respect to employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in that Contracting State. Examples of such provisions are found in Articles 15 of the current U.S. income tax treaties with France and Germany. Such a provision is also included in the income tax treaty between the United States and Denmark that was signed on August 19, 1999.

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subject to tax, but the loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

[11] We have assumed that all the flight attendants are nonresident aliens under the Code. If a particular flight attendant is a citizen or resident of the United States, it may be necessary to apply the tie-breaker rules of the residence article of the third-country treaty to determine whether the flight attendant is properly treated as a resident of the third country for purposes of that treaty.

If a flight attendant claims benefits under a third-country treaty, the examiner may verify that the flight attendant is entitled to the benefits. However, the examiner may not require a flight attendant to elect benefits under any treaty. Assuming the flight attendant has not provided documentation electing treaty benefits, the examiner also may not require the air carrier to apply any treaty in determining the amount of the flight attendant's wages that is subject to withholding.

If you have any further questions, please call (202) 622-3880.

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