

LB&I International Practice Service Concept Unit

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Volume	8	Repatriation / Withholding	Level 1 UIL	9424
Part	8.1	FDAP Payments	Level 2 UIL	9424.01
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Unit Name	FDAP Payments – Source of Income
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Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

[General Overview](#)

[Facts of Concept](#)

[Detailed Explanation of the Concept](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

General Overview

FDAP Payments - Source of Income

Overview. In general, a U.S. person is subject to U.S. tax on worldwide income. In contrast, the U.S. only taxes a foreign person (e.g., nonresident alien individuals and foreign corporations) on two categories of income: (1) income effectively connected with a trade or business in the U.S. (ECI); and (2) fixed, determinable, annual, or periodical income from sources within the U.S. that are not effectively connected with a trade or business in the U.S. (FDAP). FDAP income consists primarily of passive investment income, including interest, dividends, rents, royalties, etc. In contrast, ECI generally consists of income from active trade or business activities. FDAP is taxed on a gross basis (gross income without deductions) at 30 percent whereas ECI is taxed on a net basis (gross income less allowable deductions) at graduated rates. The 30 percent tax rate on FDAP may be reduced (or eliminated) pursuant to an income tax treaty or under domestic law.

Sourcing. This IPS unit focuses on the general rules for determining the source of income. This concept is critically important because the U.S. only has jurisdiction to tax FDAP income if it is from “sources within the United States” under the Internal Revenue Code (IRC). The IRC specifically mentions the sourcing for nine types of income: (1) interest, (2) dividends, (3) personal services, (4) rentals and royalties, (5) interests in U.S. real property; (6) inventory property, (7) underwriting income (8) social security benefits, and (9) guarantees. There may be instances in which a foreign person earns an item of income that does not fit neatly into any of the nine enumerated categories. In such situations, source may be determined by analogy to the closest category.

Withholding. Although not the focus of this IPS Unit, it is important to note that the payment of the 30% tax on FDAP income is collected by withholding at the source. Accordingly, the payor of the FDAP income is required to withhold and remit this tax to the IRS. The person who withholds and pays the tax is often referred to as the withholding agent (WA). A withholding agent that does not know the source of the income that it is paying is required to presume that the payment is U.S. source and is thus obligated to withhold.

General Overview (cont'd)

FDAP Payments - Source of Income

Determination of whether the payments are subject to withholding is a five-step process whereby examiners must consider the following.

- 1) Is the payment made to a foreign person?
- 2) If yes, is the income FDAP income? See RPW/CU/P_08.1_01(2014)
- 3) If yes, is the income U.S. source income?** Reporting on Forms 1042-S and 1042 is usually required.
- 4) If yes, is there any exemption from chapter three withholding (CTW) tax available?
Exemption from chapter three (IRC §§ 1441 to 1464) withholding at source does not mean that the payment is exempt from U.S. tax, e.g., income effectively connected with a U.S. trade or business.
- 5) If not exempt, is there a valid claim for a reduced tax rate under the code or an applicable income tax treaty?

If not 4 or 5, 30% withholding at source required.

If an item is not considered to be FDAP for purposes of Chapter 3 the item may still be considered taxable income for purposes of Chapter 1, and be subject to tax if US source.

When payment is made to a foreign person, the WA must first determine if a payment is FDAP and if withholding is required (Question 2). If a payor cannot determine the source of the income and an exemption from CTW is unavailable then it must withhold. For example, if payments are made from a U.S. company for the services of a foreign attorney the services may be FDAP income. However, the payor may not be able to determine if the payment was for services performed in the U.S. (Question 3). In such a case, the payor must withhold on the entire undetermined amount of income, but may choose to place the withheld amount in escrow until it is able to determine the source of such income (for no more than one year). However if the recipient supplies the documentation (Form W-8ECI) required to successfully assert the payment is effectively connected to the recipient's U.S. trade or business no withholding would be required (Question 4). Reporting on Form 1042-S is still required.

Facts of Concept

FDAP Payments - Source of Income

Facts of Concept

- This module assumes that a withholding agent makes a payment of FDAP income to a nonresident alien or nonresident corporation.
- See the Index of Related Issues/Topics slide for a list of IPS Practice Units that provide a closer look at different types of FDAP income to businesses, FDAP payments to individuals and others.

Detailed Explanation of the Concept

FDAP Payments - Source of Income

How to determine the source of a FDAP payment

Analysis	Resources
<ul style="list-style-type: none">▪ In most cases, dividend and interest income is from U.S. sources if it is paid by domestic corporations, U.S. citizens or resident aliens, or entities formed under the laws of the United States or a state. Income is also from U.S. sources if the property that produces the income is located in the United States, intangible property is used in the U.S., or the services for which the income is paid were performed in the United States. A payment is treated as being from sources within the United States if the source of the payment cannot be determined at the time of payment, such as fees for personal services paid before the services have been performed.▪ Withholding is required on U.S. source FDAP payments made to a foreign person, unless there is an exemption or exclusion in the IRC 1441 and 1442 regulations. Because withholding must usually occur when a gross payment is made to the foreign person, a withholding agent must withhold 30% if it cannot determine the character (dividends or interest, etc.) and source (U.S. or foreign) of payments before they are made to foreign persons.▪ Withholding agents have created different methods of reviewing payments to determine both character and source. A withholding agent might first split payments into those made to U.S. persons and to foreign persons. Then the withholding agent might consider whether each payment to foreign persons was FDAP and, if so, whether such payment was U.S. or foreign source.▪ A nonresident alien or foreign corporation is usually subject to U.S. income tax only on U.S. source income. The general rules for determining source of income that apply to all foreign recipients are shown next:	

Detailed Explanation of the Concept (cont'd)

FDAP Payments - Source of Income

How to determine the source of a FDAP payment

Analysis		Resources
Item of Income – usually FDAP	General Factors Determining Source, exceptions may apply	
▪ Interest	▪ Residence of payer	IRC 861(a)(1)
▪ Dividends	▪ Nationality/place of incorporation of payor/issuer	IRC 861(a)(2)
▪ Substitute dividends or substitute interest, as paid in securities lending and repo transactions	▪ The same source as the interest or dividend paid on the transferred securities	Treas. Reg. 1.861-2(a)(7) and 1.861-3(a)(6)
▪ Rents	▪ Location of property	IRC 861(a)(4)
▪ Royalties: Natural resources	▪ Location of property	IRC 861(a)(4)
▪ Royalties: Patents, copyrights, etc.	▪ Where property is used	IRC 861(a)(4)
▪ Business income: Personal services, whether paid to an entity or an individual	▪ Where services performed	IRC 861(a)(3)

Detailed Explanation of the Concept (cont'd)

FDAP Payments - Source of Income		
How to determine the source of a FDAP payment		
Analysis		Resources
Item of Income –usually NOT FDAP	General Factor Determining Source, exceptions apply	
<ul style="list-style-type: none"> ▪ Business income: (to a foreign corporation) when a U.S. payor purchases inventory (usually not FDAP) 	<ul style="list-style-type: none"> ▪ Where title passes 	Treas. Reg. 1.861-7
<ul style="list-style-type: none"> ▪ Business income: Sale of inventory –produced (usually not FDAP) 	<ul style="list-style-type: none"> ▪ Where produced (allocation may be necessary) 	Treas. Reg. 1.863-1
<ul style="list-style-type: none"> ▪ Sale of real property (may be subject to FIRPTA. Usually not FDAP) 	<ul style="list-style-type: none"> ▪ Location of property 	IRC 861(a)(5)
<ul style="list-style-type: none"> ▪ Sale of natural resources (may be subject to FIRPTA. Usually not FDAP) 	<ul style="list-style-type: none"> ▪ Allocation based on fair market value of product at export terminal. 	Treas. Reg 1.863–1(b)
<ul style="list-style-type: none"> ▪ Sale of personal property (usually not FDAP) 	<ul style="list-style-type: none"> ▪ Seller's tax home (but see Personal Property, in Chapter 2 of Publication 519, for exceptions) 	Pub. 519
<ul style="list-style-type: none"> ▪ Salaries, wages, other compensation, whether paid to an entity or an individual (usually not subject to withholding) 	<ul style="list-style-type: none"> ▪ Where services performed 	IRC 861(a)(3)

Detailed Explanation of the Concept (cont'd)

FDAP Payments - Source of Income

How to determine the source of a FDAP payment

Analysis	Resources
<ul style="list-style-type: none">▪ A detailed discussion of the foregoing general rules is provided in Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities-, Source of Income heading.▪ Payments may need to be allocated to components of various sources, such as services only partially performed in the U.S. Similarly, a payment may need to be allocated to components of different character, such as a purchase of an expensive machine from a foreign seller, which includes installation performed by the seller's staff. The part of the purchase price that is allocated to the services performed in the U.S. may be subject to CTW.▪ Sourcing by analogy: Where IRC 861 to 865 is silent on the source of income, the source of a payment may be determined by analogy.▪ Periodically, Congress has clarified contentious analogies.<ul style="list-style-type: none">– Fees paid by a domestic borrower for the provision of a guarantee of indebtedness are U.S. source.– Payments determined based on U.S. source dividends made pursuant certain equity derivatives (such as total return swaps) will be sourced to the U.S. if they are treated as dividend equivalents under section 871(m).	Pub. 515 IRC 861(a)(9) and 871(m) Treas. Reg 1.871-15

Detailed Explanation of the Concept (cont'd)

FDAP Payments - Source of Income

How to determine the source of a FDAP payment

Analysis	Resources
<ul style="list-style-type: none"> ▪ Notional Principal Contract Income: Generally, the source of notional principal contract income is determined by reference to the residence of the taxpayer. This rule does not apply to a dividend equivalent described in IRC 871(m) and Treas. Reg. 1.871-15. ▪ Gain on sale of intangibles contingent on productivity/use:; When a U.S. business buys intangible property or patents, such as copyrights, secret processes or formulas, goodwill, trademarks, trade brands or franchises from a foreign seller, and agrees to pay for the intangibles contingent on the intangible property's productivity, the payment is U.S. source FDAP income to the seller, not sales proceeds. This is because the contingent payments make the transaction closer to a royalty than a purchase. ▪ For U.S. corporations that earn at least 80% of their gross income from foreign sales, dividends these corporations pay is foreign source in the proportion that the gross income is from foreign sources. E.g., if the U.S. corporation's revenue is 73% from foreign sales, its dividends are 100% U.S. source. If its revenue is 84% from foreign sales, its dividend payments are 84% foreign source. Interest paid by these "80/20" companies is only foreign source if the 80/20 company existed in 2010. There are further limitations on this exemption. See Publication 515. 	<p>Treas. Reg. 1.863-7(b)(1)</p> <p>IRC 865(d)(1)(B)</p> <p>Pub. 515</p>

Training and Additional Resources

FDAP Payments - Source of Income		
Type of Resource	Description(s) and/or Instructions for Accessing	References
IRS.gov	<ul style="list-style-type: none"> Hyperlinked pages on numerous "NRA Withholding" topics 	<ul style="list-style-type: none"> http://www.irs.gov/Individuals/International-Taxpayers/NRA-Withholding
FPP Training	<ul style="list-style-type: none"> PPT for Non 2012 Resident Alien Withholding Training. See Deck 701 FDAP Income, especially slides 14 to 29. 	<ul style="list-style-type: none"> PPT for 2012 (IBC) CPE - Non Resident Alien Withholding Form 1042 Audit Techniques-August, 2012.

Glossary of Terms and Acronyms

Acronym	Definition
CTW	Chapter Three Withholding in IRC § 1441-1464
ECI	Effectively Connected Income (to a U.S. trade or business)
FDAP	Fixed or determinable, annual or periodic income
NRA	Nonresident alien individual - IRC § 7701(b)(1)(B)
IPN	International Practice Network
IPS	International Practice Service
UIL	Uniform Issue List

Index of Related Issues

Issue	Associated UIL(s)	References
FDAP Payments – FDAP Income	▪ 9424.01 Repatriation / Withholding – FDAP Payments	▪ RPW/CU/P_08.1_02(2016)
FDAP Payments – FDAP Withholding under Chapter 3	▪ 9424.01 Repatriation / Withholding – FDAP Payments	▪ RPW/CU/P_08.1_03(2016)
Overview of FDAP	▪ 9422.01-01 Non-Resident Alien Claims for Refunds of Withheld FDAP Amounts	▪ WIT/CU/P_15.1_01(2014)