

Foreign Recipients of U.S. Income, 2010

by Scott Luttrell

Whenever a U.S. entity (the payer) distributes U.S.-source income to foreign persons, it is required to withhold taxes on the income (except where statutory or treaty exemptions apply) or to appoint a third-party withholding agent to do so. Foreign financial institutions that enter into an agreement with the Internal Revenue Service (IRS), known as qualified intermediaries (QIs), may also serve as withholding agents. The payer or withholding agent is fully liable for all taxes owed and is required to report the income paid to each foreign recipient on a Form 1042-S, *Foreign Person's U.S.-Source Income Subject to Withholding*. Absent this withholding requirement, there would be no effective way to enforce taxpayer compliance, because foreign recipients are generally not required to file U.S. tax returns to report this income.

The principal types of income reported on Form 1042-S include interest, dividends, rents, royalties, Social Security and railroad retirement payments, and personal services income, shown separately in Table 2. Other types of income include capital gains, scholarships, pensions and annuities, gambling winnings, and certain real estate distributions. Bank deposit interest and certain other interest payments on specific types of financial obligations are generally not reported on Form 1042-S.¹

As most foreign recipients are not required to file U.S. tax returns, it is generally not possible to tax them at ordinary graduated rates on their consolidated U.S.-source income.² Therefore, the statutory withholding rate for income paid to foreign persons is 30 percent. The flat, statutory rate is frequently reduced or eliminated by an income tax treaty or statutory exemption (see Table 1 for the amount of income exempt from taxation). Income that is exempt from taxation because of a tax treaty or certain other exemptions generally must still be reported by the withholding agent on Form 1042-S.

Data Highlights

During Calendar Year 2010, foreign persons received \$557.8 billion in U.S.-source income, as reported on Form 1042-S, and \$499.8 billion (89.6 percent) of this

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income was exempt from withholding taxes. These figures represent increases from 2009 of 2.1 percent and 1.3 percent, respectively. A total of \$10.1 billion in taxes was withheld on the residual \$58.0 billion of income subject to withholding tax. The 65 countries with which the United States maintained a comprehensive tax treaty in 2010 accounted for \$450.8 billion of the total U.S. income paid to foreign persons and \$6.4 billion of the tax withheld (Table 1).

Residents in each of 13 nontreaty jurisdictions received a total of more than \$1 billion of U.S.-source income in 2010: the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Gabon, Guernsey, Hong Kong, Kuwait, Puerto Rico, Saudi Arabia, Singapore, Taiwan, and the United Arab Emirates (Table 2). All nontreaty countries combined to account for 19.2 percent of total income and 36.3 percent of total tax withheld. The average effective tax rate on payments subject to withholding to residents of nontreaty countries was 23.9 percent, compared with 11.0 percent on payments to residents of treaty countries.

Residents of the United Kingdom, Japan, Germany, the Cayman Islands, Switzerland, France, Luxembourg, Canada, the Netherlands, and Belgium received the largest shares of U.S.-source income in 2010 (see Figure A). Recipients from these 10 countries combined to account for 74.2 percent of total income. Residents from the U.K. received 15.3 percent of all income in 2010, down from 17.6 percent in 2009. Japanese recipients collected 10.0 percent of total U.S. income paid to foreign persons, down from 11.0 percent in 2009. Shares of U.S.-source income paid to French, Canadian, and Dutch recipients all increased by at least 0.8 percent from 2009 to 2010.

In 2010 the largest amounts of tax withheld were paid by residents of the Cayman Islands, Canada, Luxembourg, the United Kingdom, Switzerland, Ireland, Australia, Japan, France, Mexico, Bermuda, and Germany. Tax withheld on payments to residents of these countries made up 63.4 percent of total tax withheld. The Cayman Islands accounted for the largest share of any single country with 10.8 percent of total taxes, although their share fell from 13.3 percent in 2009. Payments to Swiss recipients saw the largest increase in tax withheld, accounting for 5.6 percent, up from 2.4 percent in 2009.

Among recipient categories, corporations received the majority of U.S.-source income with \$400.2 billion

¹ U.S. Department of the Treasury, Internal Revenue Service, Instructions for Form 1042-S. Bank deposit interest is generally excluded from Form 1042-S reporting, although an exception exists for Canadian residents who are not U.S. citizens. Bank deposit interest paid to Canadian residents is subject to Form 1042-S reporting but is exempt from withholding tax. In addition to bank deposit interest, other payments to foreign persons that are not subject to reporting on Form 1042-S include: interest and original issue discount (OID) from short-term obligations, registered obligations targeted to foreign markets, bearer obligations targeted to foreign markets, notional principal contract payments that are not effectively connected income, and accrued interest and OID. Data for these types of income are not available from other sources.

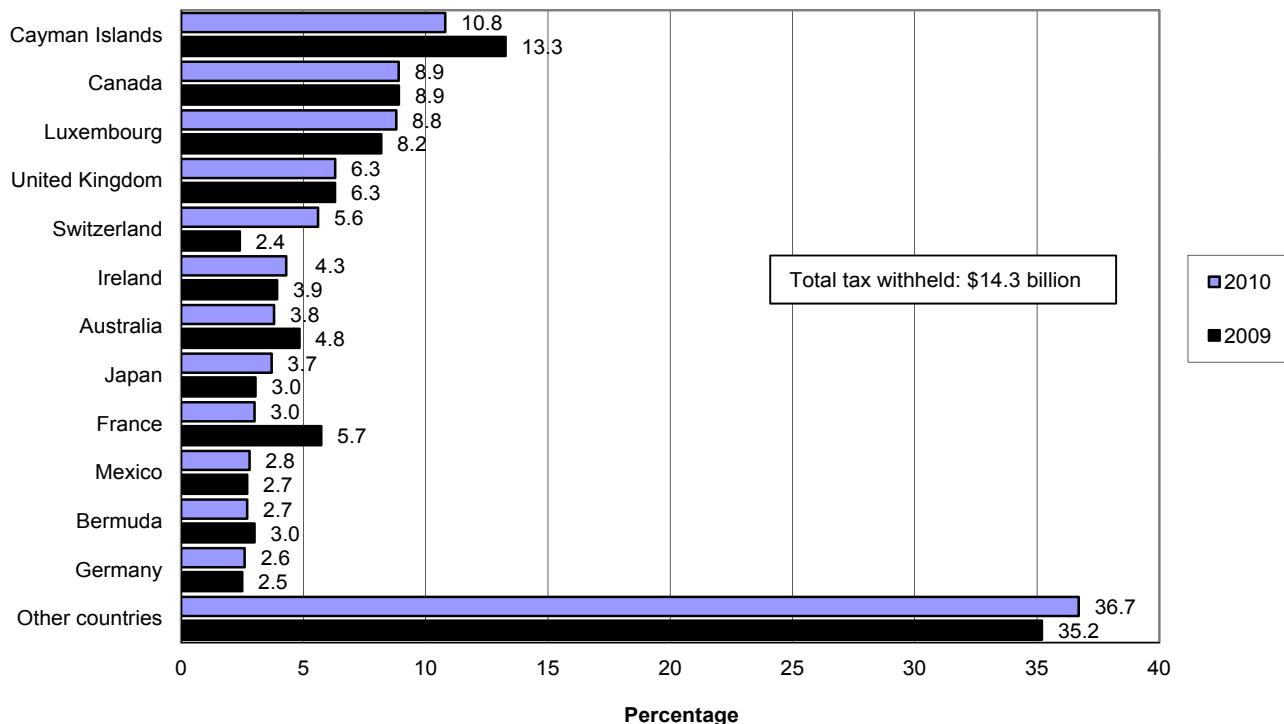
² An exception to this general rule exists in some cases for personal services income.

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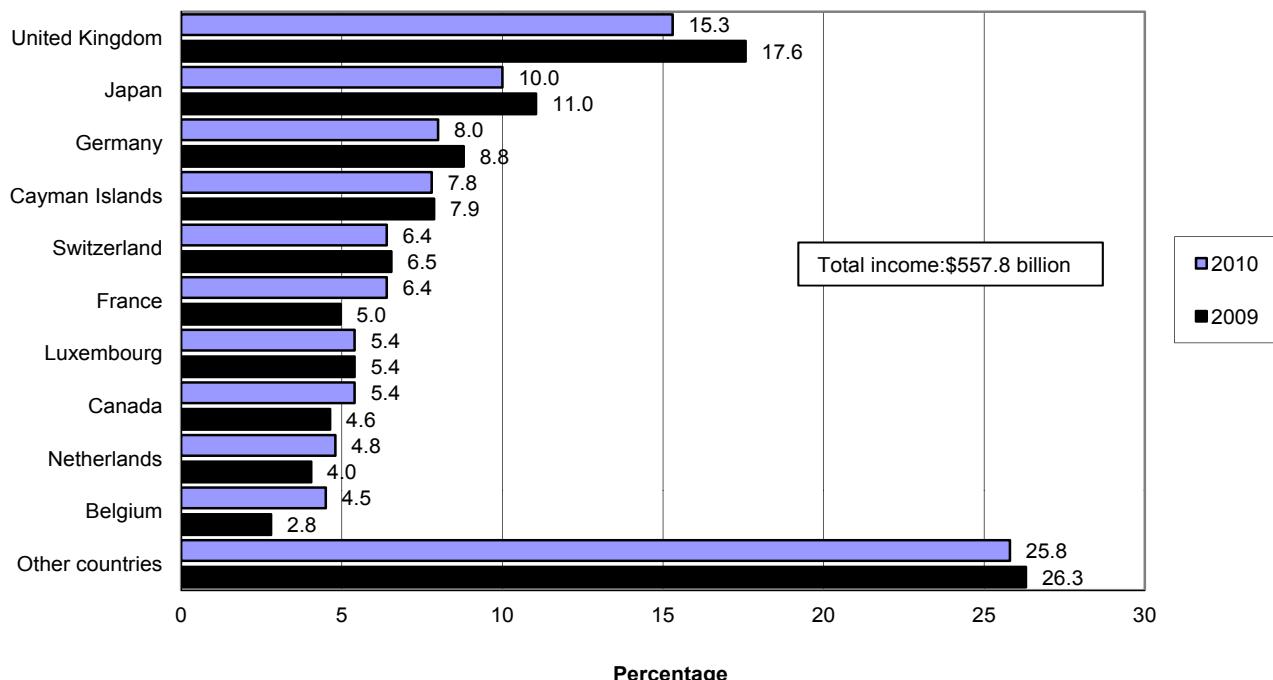
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Figure A

Percentage of Total Taxes Withheld, by Country of Foreign Recipient, 2009 and 2010



Percentage of Total Income Paid, by Country of Foreign Recipient, 2009 and 2010



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(71.7 percent). Governments and international organizations were next with \$38.6 billion (6.9 percent), followed by partnerships and trusts with \$16.2 billion (2.9 percent). Recipients classified as individuals accounted for just 2.2 percent (\$12.5 billion) of the total. The largest amounts of tax were withheld on payments made to corporations (52.8 percent) and individuals (10.0 percent). The recipient category QI pools (see Explanation of Selected Terms), shown in Table 2 and Figure B, represents payments made from QIs directly to beneficial owners (or payments that are treated as paid directly to beneficial owners). QI pool payments may include income payable to more than one category of recipient. As such, it is not possible to classify these payments into specific recipient categories. In 2010, payments to QI pools made up 12.9 percent of total income and contributed 24.9 percent of total tax withheld.

U.S. income paid to foreign persons is classified under 1 of 37 possible income categories. Most of these income categories are devoted to specific types of interest, dividends, and passive types of income. For 2010, interest payments (\$261.2 billion) accounted for the largest amount of income paid to foreign recipients, accounting for 46.8 percent of the total. Dividends (\$111.4 billion) made up 20.0 percent of total income while notional

principal contract income (\$86.2 billion) made up 15.4 percent. A notional principal contract is a contract involving two parties who agree contractually to pay each other amounts at specified times, based on the underlying notional amount. The underlying amount is notional because neither party to the notional principal contract is required to actually hold the property comprising the underlying amount. Notional principal contracts are used by financial institutions to reduce the risk of changes in interest rates, commodity prices, and currency exchange rates. Interest rate swaps, currency swaps, and equity swaps are examples of notional principal contracts.³ The next most significant income category was rents and royalties (\$39.6 billion) which accounted for 7.1 percent of total income.

The effective tax rate on all U.S.-source income subject to withholding, as reported on Form 1042-S in 2010, was 17.5 percent. This was significantly below the statutory rate of 30 percent, due largely to reduced withholding rates permitted under tax treaties.

Tax withheld varied among recipient types. For corporations, the effective tax rate was 15.2 percent, on average for 2010. While corporations reported the largest share of income subject to withholding tax for that year, they also reported the largest amounts of dividends

Figure B

U.S.-Source Payments to Foreign Persons: Income, Tax Withheld, and Effective Tax Rate, by Recipient Type, 2010

[Money amounts are in thousands of dollars]

Recipient type	U.S.-source income			U.S. tax withheld	Effective tax rate on income subject to withholding tax [1]
	Total	Exempt from withholding	Subject to withholding		
	(1)	(2)	(3)	(4)	(5)
All recipients	557,779,494	499,782,728	57,996,766	10,123,036	17.5
Individuals	12,492,493	7,828,472	4,664,021	1,008,194	21.6
Corporations	400,175,642	364,983,757	35,191,885	5,341,444	15.2
Partnerships/trusts	16,191,433	13,934,581	2,256,852	489,135	21.7
U.S. branches treated as U.S. persons	2,959,827	2,949,642	10,185	1,145	11.2
Governments and international organizations	38,615,089	38,502,936	112,154	20,789	18.5
Tax-exempt organizations	2,361,759	2,277,918	83,842	16,959	20.2
Private foundations	155,592	58,660	96,932	5,873	6.1
Artists and athletes	546,949	89,404	457,546	136,487	29.8
Qualified intermediary pools	71,978,492	58,986,253	12,992,239	2,516,779	19.4
Other/unknown	12,302,218	10,171,105	2,131,110	586,231	27.5

[1] U.S. tax withheld divided by U.S.-source income subject to withholding.

NOTES: Detail may not add to totals because of rounding. Percentages are computed using rounded data.

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and royalties, which are subject to reduced withholding rates under tax treaties (Figure B). For individuals, the effective tax rate was 21.6 percent. Individuals received 24.5 percent of total income subject to withholding from personal services, Social Security income, and railroad retirement benefits, which are less likely to benefit from reduced treaty rates.

In contrast, individual recipients received 24.5 percent of total income subject to withholding in the form of personal services income and Social Security and railroad retirement benefits, which are less likely to benefit from reduced treaty rates. The effective tax rate for individual recipients was 21.6 percent.

Additional Foreign Income and Withholding Data

To compile the entirety of withholding tax on foreign persons' U.S. income, it is necessary to combine the data from Form 1042-S with information from additional tax forms. U.S. partnership income that is allocable to foreign partners is reported on Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*. Domestic partnerships are required to withhold income tax on effectively connected taxable income deemed allocable to foreign partners. A U.S. partnership files a Form 8805 to show the amount of taxable income and total tax allocable to the foreign partner for the partnership's tax year.⁴ The statutory withholding rate for partnership income allocable to foreign partners is 35 percent. Reduced withholding rates may apply if the foreign partner is an individual and the specific type of income is among those subject to preferential rates. These types of income include capital gains, depreciation recapture, and collectibles gains.

Another tax form that provides information about withholding on foreign persons' U.S. income is the Form 8288-A. The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) was introduced to ensure that the U.S. collected a portion of the capital gains realized by foreigners from the sales of U.S. real property interests. The sales price of U.S. real property sold by the foreign person and the tax withheld on that sales price is reported on Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*.⁵ Typically, the sales price is subject to 10-percent withholding, although corporations may be taxed at rates up to 35 percent in certain circumstances. In some instances the seller may elect to pay a 35-percent tax

on the capital gain rather than a 10-percent withholding tax on the sales price. When a foreign person sells real property interests in the United States, the buyer of the property is responsible for collecting and remitting to the IRS the appropriate amount of withholding and filing the necessary tax forms.

A withholding tax equivalent on foreign person's U.S. income in the form of a branch profits tax is reported on Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*. The branch profits tax was created to achieve neutrality for foreign investments in the United States through a U.S. branch or a U.S. subsidiary of a foreign parent corporation. While dividends paid by a U.S. subsidiary to its foreign parent corporation are subject to a 30-percent (or lower) withholding tax, profits of a U.S. branch of a foreign parent would not be subject to an equivalent tax absent the branch profits tax. The amount of income remitted from the U.S. branch to its foreign owner, known as the dividend equivalent amount, is reported on Form 1120-F, along with the associated tax on that amount (i.e., branch profits tax).

The combined withholding tax on U.S.-source income paid to foreign persons for 2010 was \$14.3 billion, with an average effective tax rate of 19.2 percent (Figure C). The effective withholding rates vary widely among the various tax forms. U.S. partnership income allocable to foreign partners is subject to significantly higher rates of withholding than other types of U.S. income because it is not typically reduced by tax treaties and is far more likely to be taxed near the statutory 35-percent tax rate. For 2010, the average effective withholding rate on U.S. partnership distributions to foreign partners was 32.2 percent. The 9.5-percent withholding rate on income from the sale of U.S. real property interests is comparatively low because the statutory rate for this type of income is just 10 percent. The average effective rate on foreign branch profits reported on Form 1120-F was only half of the 30-percent statutory rate because recipients frequently qualify for reduced rates through tax treaties.

The five States with the most U.S. real property interest sales in 2010 made up 56.4 percent of all transactions, 46.6 percent of the total sales revenue, and 49.1 percent of taxes withheld (Figure D). The largest number of real property sales occurred in Florida. In fact, Florida had more than 3.5 times more transactions than New York, which had the second most transactions in 2010. Many real property sales could not be assigned to a specific State for reasons including: the real property transaction

⁴ A withholding credit for the tax withheld by the partnership can be claimed by the partner when the partner attaches Form 8805 to his or her U.S. income tax return.

⁵ For purposes of this article and the accompanying data tables, the terms "sales price" and "income" are used interchangeably to refer to the sales price of disposed U.S. real property interests reported on Form 8288-A. See Figure C, columns 2 and 4.

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Figure C

U.S.-Source Payments to Foreign Persons: Number of Forms, Income, and Tax Withheld, by IRS Form Type and Selected Country, 2010

[Money amounts are in thousands of dollars]

Form and selected country	All payments		Payments subject to withholding tax			
	Total number of forms	Income (less loss)	Number of forms [1]	Income [2]	U.S. tax withheld	Effective tax rate [3]
				(1)	(2)	(3)
All forms	3,601,705	575,388,603	2,140,542	74,459,941	14,307,267	19.2
Form 1042-S: All countries	3,362,405	557,779,494	2,020,993	57,996,767	10,123,036	17.5
United Kingdom	363,551	85,586,487	224,302	3,834,269	639,655	16.7
Japan	133,097	55,870,675	49,164	3,786,644	376,293	9.9
Germany	286,791	44,542,844	164,698	1,553,240	259,759	16.7
Cayman Islands	86,055	43,468,124	28,510	3,719,692	1,096,111	29.5
France	66,172	35,890,497	41,448	2,301,903	303,880	13.2
Switzerland	48,448	35,796,845	29,058	4,023,317	569,910	14.2
Luxembourg	9,009	30,253,886	3,861	3,256,487	893,477	27.4
Canada	522,335	30,127,010	300,548	7,898,999	904,330	11.4
Netherlands	54,042	26,905,924	27,690	1,378,628	149,880	10.9
Belgium	25,545	25,285,736	18,370	824,645	171,410	20.8
Ireland	48,930	12,901,376	31,225	2,214,849	438,692	19.8
Australia	181,104	10,203,821	141,918	3,010,073	383,656	12.7
Sweden	21,745	9,752,937	16,995	650,037	87,332	13.4
Bermuda	18,315	9,219,846	7,893	912,422	269,369	29.5
Spain	38,881	6,592,797	28,645	573,076	77,106	13.5
China	114,573	6,591,146	36,971	360,881	49,912	13.8
Hungary	5,046	6,135,161	3,152	2,190,329	112,523	5.1
Norway	9,680	5,250,360	6,868	188,432	29,954	15.9
Mexico	147,941	5,003,421	114,437	2,038,063	287,151	14.1
Singapore	59,958	4,878,739	43,706	242,326	67,606	27.9
British Virgin Islands	60,081	4,498,784	27,487	743,890	221,852	29.8
Form 8805: All countries [4]	229,845	9,178,644	110,511	11,265,695	3,632,683	32.2
Jersey	163	1,701,354	112	1,711,572	598,433	35.0
Germany	175,213	1,358,750	73,883	1,740,153	423,934	24.4
Sweden	292	1,353,665	189	1,355,839	474,131	35.0
United Kingdom	6,481	1,089,774	4,462	1,297,540	444,289	34.2
Switzerland	1,565	604,969	955	622,053	215,653	34.7
France	1,218	579,754	842	592,587	211,237	35.6
Netherlands	1,312	349,606	812	458,534	151,400	33.0
Form 8288-A: All countries	7,982	4,158,164	7,982	4,158,164	395,353	9.5
United Kingdom	828	1,315,020	828	1,315,020	131,555	10.0
Canada	1,759	565,799	1,759	565,799	39,082	6.9
Germany	1,892	340,316	1,892	340,316	32,237	9.5
Switzerland	77	218,457	77	218,457	21,846	10.0
Form 1120-F: Reporting branch profits tax	1,473	4,272,301	1,059	1,039,315	156,195	15.0

[1] Number of forms in this column includes returns with income subject to taxation for Form 1042-S, *Foreign Person's U.S.-Source Income Subject to Withholding*; positive income (excluding losses) for Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*; sales revenue for Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*; and branch profits tax for Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*.

[2] Amounts in this column represent income subject to taxation for Form 1042-S; positive income (excluding losses) for Form 8805; sales price for Form 8288-A; and dividend equivalent amount subject to taxation for Form 1120-F.

[3] U.S. tax withheld (column 5) divided by income (column 4).

[4] Income (less loss) for all payments (column 2) is less than income on payments subject to tax (column 4) because column 2 includes forms with losses.

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Figure D

Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests, 2010: Sales Price and Tax Withheld as Reported on Form 8288-A, by Selected State

[Money amounts are in thousands of dollars]

State location of real property	Total number of forms	Total sales revenue	U.S. tax withheld
	(1)	(2)	(3)
Total	7,982	4,158,164	395,353
Florida	2,615	666,983	66,965
California	584	469,833	47,099
New York	729	429,112	43,045
Tennessee	10	189,150	18,709
Hawaii	564	183,471	18,375
All others	3,480	2,219,615	201,160

involved the transfer of stock in a portfolio of real estate holdings not specific to a geographic area, or the transaction involved the sale of an ownership interest in an entity which controlled real estate in multiple locations in the United States.

Data Sources and Limitations

Payers (or their authorized withholding agents) of most U.S.-source income to foreign persons must withhold tax in accordance with Internal Revenue Code section 1441. Form 1042-S, *Foreign Person's U.S.-Source Income Subject to Withholding*, is filed by the payer to report this income and the U.S. tax withheld. Often a financial institution acts as the payer's withholding agent. The statistics in this data release were tabulated by calendar year, using all Forms 1042-S filed with the Internal Revenue Service during 2010. The data reflect the income that was paid and U.S. tax that was withheld for 2010.

Domestic partnerships (or their authorized withholding agents) must withhold tax in accordance with Internal Revenue Code section 1446 on distributions made to foreign partners. Form 8805, *Foreign Partner's Information Statement of Section 1446 Withholding Tax*, is filed by the payer to report income paid by U.S. partnerships to their foreign partners and the U.S. tax withheld. The statistics in this data release were tabulated by calendar year, using all Forms 8805 filed with the Internal Revenue Service during 2010. The data reflect the income that was paid and U.S. tax that was withheld for 2010.

Purchasers of U.S. real property held by foreign persons must withhold tax in accordance with Internal Revenue Code section 1445. Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S.*

Real Property Interests, is filed by the buyer of U.S. real property sold by foreign persons. The statistics in this data release were tabulated by calendar year using all Forms 8288-A filed with the Internal Revenue Service with a date of transfer occurring during 2010.

In accordance with Section 884(a), a 30-percent branch profits tax is imposed on after-tax earnings of a foreign corporation's U.S. trade or business that are not reinvested in a U.S. trade or business by the close of the tax year, or are disinvested in a later tax year. Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*, is filed by the foreign corporation. The statistics in this data release were tabulated by SOI Year based upon all Forms 1120-F included in the Tax Year 2010 SOI Corporate sample.

Because the population of Forms 1042-S, Forms 8805, and Forms 8288-A were used for the statistics, the data are not subject to sampling error. However, the data are subject to nonsampling error, including data entry and taxpayer reporting errors. Although the data were subjected to tests for certain basic mathematical relationships, including the calculation of the correct tax withheld, the possibility of error cannot be completely eliminated.

Explanation of Selected Terms

Foreign persons—For purposes of this data release, foreign persons include: (a) individuals whose residence is not within the United States and who are not U.S. citizens (i.e., nonresident aliens); and (b) corporations and other organizations (including partnerships, private foundations, estates, and trusts) created or organized outside the United States. Individuals residing, and organizations created or organized, in Puerto Rico and U.S. possessions are also considered foreign persons.

Notional principal contract income—Notional principal contracts involve two parties who agree contractually to pay each other amounts at specified times, based on the underlying contract. The notional amount is an amount specified in the contract and, based on that amount, certain calculations are made. Generally, when amounts under the contract are due at the same time, they are netted, and only one payment is made. Notional principal contract income is not subject to withholding but must be reported on Form 1042-S, if the income is effectively connected with the conduct of a trade or business in the United States.

Qualified intermediary pool—Payments made by a qualified intermediary directly to beneficial owners may generally be reported on the basis of reporting pools. A reporting pool consists of income that falls within a par-

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ticular withholding rate and within a particular income type, exemption type, or recipient type.

U.S. branch treated as U.S. person—The following types of U.S. branches (of foreign entities) may reach an agreement with a withholding agent to treat a branch as a U.S. person: (a) a U.S. branch of a foreign bank subject

to regulatory supervision by the Federal Reserve Board or (b) a U.S. branch of a foreign insurance company required to file an annual statement on a form approved by the National Association of Insurance Commissioners with the insurance department of a State, territory, or the District of Columbia.