



Federal Agency Seminar 2011

Withholding and Reporting of Income Tax on Non-Wage Payments to Foreign Persons

Presented by
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Overview

- Review of IRC §§ 1441
- Review of the rules to withhold on certain non-wage payments
- Reporting of the withholding

Foreign Persons is a ...

- A nonresident alien individual (NRA);
- A corporation created or organized in a foreign country or under the laws of a foreign country;
- A partnership created or organized in a foreign country or under the laws of a foreign country;
- A foreign trust;
- A foreign estate; or
- Any other person that is not a U.S. person.



Withholding On Payments To Foreign Persons

- §1441 provides for the assessment of withholding tax on payments made to Non-Resident Alien (NRA) Individuals
- §1442 provides for the assessment of withholding tax on payments made to Foreign Corporations
- §1441 rules follow §1442

Who is require to withhold?

- Withholding Agent
 - Any person, U.S. or foreign
 - Who pays or causes to be paid any item of income on which withholding is required

What income is subject to withholding?

- **F**ixed **D**eterminable **A**nnual or **P**eriodical
- Certain gains from the disposal of timber, coal, or domestic iron ore with a retained economic interest
- Gains relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property

FDAP income is ...

- Gambling winnings
- Interest
- Dividends
- Rents
- Salaries
- Wages
- Premiums
- Annuities
- Compensation
- Remunerations
- Emoluments

Foreign Person are subject to withholding on ...

- U.S. source income
 - Income paid by domestic corporations, USC or RA, or entities formed under the laws of the United States or a state
 - Income produced by property located in the United States
 - Income for services which were performed in the United States

It is not based on ...

- Where the contract was negotiated and signed
- The place or currency of payment
- The nationality or residence of the performer or the recipient of the services

Sourcing Examples

Type of Income	How Source Determined
Compensation for Personal Services	Where Services are Performed
Interest	Residence of Payer
Dividends	Residence of Corporation
Rent	Where Real Property Located
Royalties	Where Intangible Property Used
Pensions due to Personal Services	Where Services are Performed
Scholarships and Fellowship Grants	Generally, Residence of Payer



Tax Residency

- Resident Alien
- Non-Resident Alien
- Dual-Status Taxpayer

Tax residency is based on...

- Green Card Test – A lawful permanent resident of the U.S.
- Substantial Presence Test – Numerical formula for counting days of presence in the U.S. over a 3 year period



Exempt Individuals from the SPT

- 5-calendar-year non-resident rule for students. They are individuals typically issued an F, J, M or Q visa
- 2/7-calendar-year nonresident rule for teachers and trainees

Why tax residency?

- A resident alien is a U.S. Person, and is usually taxed the same as a U.S. citizen **on world wide income**
- A nonresident alien is a Foreign Person, and is subject to special rules of taxation **on U.S. sourced income**



Withholding agent doesn't know the tax residency

In general, if a withholding agent cannot reliably associate a payment with valid documentation (e.g. Form 8233, W-8BEN, W-9, W-4) and has no actual knowledge the withholding agent must presume a U.S. person.



Other presumption rules...

- Payments to exempt recipients
- Scholarships and fellowship grants
- Pension, annuities
- Payments to offshore accounts
- Services



Presumption Rules

- You are not permitted to apply a reduced rate based on a payee's presumed status if documentation is required to establish a reduced rate of withholding
- Example: If payee is presumed to be foreign you cannot apply a reduced tax treaty rate



The amount of the withholding is...

- 30% of the gross payment.

Withholding less than 30% if...

- Income Tax treaty benefits are claimed on Form 8233
- Centralized Withholding Agreement (CWA) is entered into.
- Certain scholarship & grants are paid.
- Payment meets an exception under IRC § 1441(c).

Withholding less than 30% if...

- Personal exemption is claimed on Form 8233.
- Final payment exemption is claimed.
- Travel expenses are if paid under accountable plan rules.



Income Tax Treaties

- In general, the treaty applies to federal income taxes imposed by the Internal Revenue Code
- Tax Treaties do not generally provide exemptions for FICA/FUTA taxes



Income Tax Treaties

- Reduced rate, exclusion amount or no withholding
- Treaty Benefit must be claimed by the Foreign Person
 - Resident of the treaty country
 - Beneficial owner of the income
 - Meets any limitations set forth in the treaty

A lower tax rate is claimed on...

- Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Service of a Nonresident Alien Individual*
- Non-personal services income (e.g. royalties) file Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*

IRC § 1441(c) Exceptions

- No IRC § 1441 withholding on any item of income which is effectively connected with the conduct of a trade or business in the U.S. (A.K.A ECI = effectively connected income)
- Taxed similar to a U.S. Person
- A Form W-8ECI is presented to claim this exception

We have learned so far...

- A withholding agent is requires W/H tax under §1441/1442 when there is:
 - A payment to a Foreign Person;
 - It is FDAP income; and
 - It is U.S. sourced income.
- The Withholding Agent must receive Form W-8BEN, W-8ECI, or 8233 to withhold at a rate lower than 30%

Examples of non-wage payments

- Pay for independent personal services
- Royalties
- Interest
- Grants
- Rents
- Pension distributions
- Dividends
- Scholarships and fellowship grants



Independent Personal Services

- Personal services performed by an independent non-resident contractor
- Withhold at the statutory 30%
- Services must be provided in the U.S.



Scholarships and fellowship grants

- An amount given to an individual for study, training or research, and which doesn't constitute compensation for personal services
- Grantor which resides in the U.S. are treated as U.S. source income



Degree candidate

- Don't withhold on a qualified scholarship payments
- Withhold 14% on non-qualified scholarship payments present in F, J, M, or Q non-immigration status
- Withholding 30% on non-qualified scholarship payments if in U.S. under another status

Non-degree candidate

- Withhold at 14% on the total amount if the following are met-
 - Grant must be study, training or research in the U.S
 - Grant must be by
 - Tax exempt organization
 - Foreign government
 - Federal, state, or local government
 - International organization



Other Grants, prizes & awards

- Grantor which reside in the U.S. are treated as U.S. source income
- Not U.S. source income
 - Activities conducted outside the U.S.
 - Grantors that reside outside the U.S.
- Withholding at 30%



Contingent Interest

- Interest on any receipts, sales, or other cash flow of the debtor
- Subject to 30% withholding
- Claim treaty benefits on a W-8BEN



What did we learn?

- Generally you withhold 30% on payments to foreign person with certain exceptions
- For treaty benefits or personal exemptions the payee must claim these benefits

Form 1042

- Annual return used by withholding agents to report tax withheld at source on certain income paid to foreign persons not engaged in trade or business in the United States.
- Withhold and remit to IRS per deposit requirements
- File by March 15

Form 1042-S

- Information return prepared by the withholding agent
- A copy provided to the payee and IRS
- Should indicate the amount of income earned, tax withheld and information identifying the withholding agent and the payee
- Reconcile all Forms 1042-S to the Form 1042 filed
- File by March 15th

1 Income code	2 Gross income	3 Withholding allowances	4 Net income	5 Tax rate	7 Federal tax withheld
					8 Withholding by other agents
				6 Exemption code	9 Total withholding credit
10 Amount repaid to recipient				14 Recipient's U.S. TIN, if any ▶ <input type="checkbox"/> SSN or ITIN <input type="checkbox"/> EIN <input type="checkbox"/> QI-EIN	
11 Withholding agent's EIN ▶ <input type="checkbox"/> EIN <input type="checkbox"/> QI-EIN			15 Recipient's foreign tax identifying number, if any		16 Country code
12a WITHHOLDING AGENT'S name				17 NQI's/FLOW-THROUGH ENTITY'S name	
12b Address (number and street)				18 Country code	
12c Additional address line (room or suite no.)				19a NQI's/Entity's address (number and street)	
12d City or town, province or state, country, ZIP or foreign postal code				19b Additional address line (room or suite no.)	
13a RECIPIENT'S name				19c City or town, province or state, country, ZIP or foreign postal code	
13b Recipient code			20 NQI's/Entity's U.S. TIN, if any ▶		
13c Address (number and street)				21 PAYER'S name and TIN (if different from withholding agent's)	
13d Additional address line (room or suite no.)				22 Recipient account number (optional)	
13e City or town, province or state, country, ZIP or foreign postal code				23 State income tax withheld	24 Payer's state tax no.
				25 Name of state	

For Privacy Act and Paperwork Reduction Act Notice, see page 17 of the separate instructions.

Cat. No. 11386R

Form **1042-S** (2011)

At a minimum, information must be in the highlighted fields, but other boxes must be completed if the nature of the payment requires it.



Form 1042-S Items

- Complete the required fields
- Use only income, recipient, exemption, and country codes specifically listed in Form 1042-S instructions.
- Gross income reported in box 2 cannot be “0”



Form 1042-S Items

- The income code you report in box 1 must correctly reflect the type of income you paid the recipient.
- Be sure withholding agent's name matches the name that was applied for with the EIN & use this name consistently on all the Form 1042-S



Common errors to avoid

- Box 7: Federal tax withheld inconsistent with valid tax rate
- Box 13b: Unknown recipient code "20" in Box 13b, but a name is in Box 13a
- Box 13a: Name in Box 13a inconsistent with recipient code in Box 13b, e.g., name is "pension fund" and code is "individual"



Common errors to avoid

- Box 14: No TIN, but exemption code in “01” indicating income effectively connected with a U.S. trade or business
- Box 13e: Address country of residence is not consistent with country code in Box 16; “OC” and “UC” will create error codes, particularly if treaty benefits are claimed
- Not all required fields are complete!

Form 1042-T

- Form 1042-T must be attached to the Forms 1042-S being transmitted
- Withholding agent name, address, & EIN used must match the Forms 1042 and 1042-S

Form 10402-T

DO NOT STAPLE

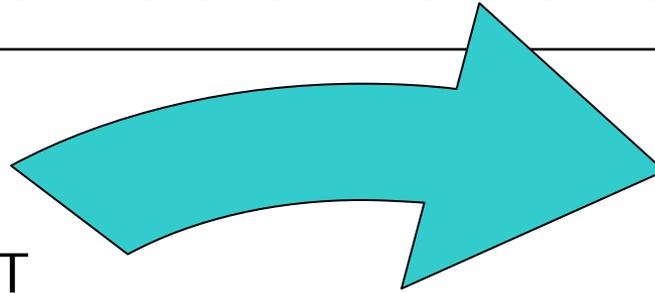
Form 1042-T Department of the Treasury Internal Revenue Service	Annual Summary and Transmittal of Forms 1042-S	OMB No. 1545-0096 2010
Name of withholding agent		Employer identification number
Number, street, and room or suite no.		
City or town, province or state, and country (including postal code)		
If you are an intermediary (see Form 1042 instructions), check if you are a: <input type="checkbox"/> QI/Withholding foreign partnership or trust <input type="checkbox"/> NQI/Flow-through entity		
1a Type of paper Forms 1042-S attached (check only one box): <input type="checkbox"/> Original <input type="checkbox"/> Amended Also check here if pro-rata (see instructions) <input type="checkbox"/>		
b Number of paper Forms 1042-S attached		
2a Total gross income on all paper Forms 1042-S (box 2) attached		\$
b Total federal tax withheld on all paper Forms 1042-S (box 9) attached		\$
<p>Caution: <i>If you have already filed a Form 1042 and an attached Form 1042-S causes the gross income or tax withheld information shown on your previously filed Form 1042 to change, you must file an amended Form 1042. See the instructions below.</i></p>		
If this is your FINAL return, enter an "X" here (see instructions) . . . <input type="checkbox"/>		

Please return this entire page to the Internal Revenue Service.

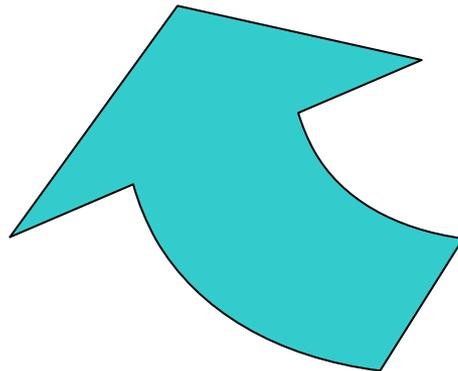
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying documents, and to the best of my knowledge and belief, they are true, correct, and complete.		
	Your signature	Title	Date
			Daytime phone number

Reconciliation of the Forms

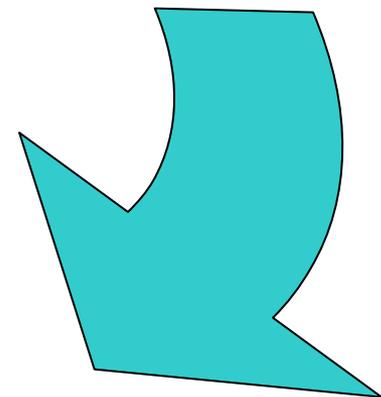
Form 1042-T
Box 2a
Box 2B



Form 1042
Box 62a
Box 62b



Form 1042-S
Box 2
Box 9





Summary

- Reviewed the basic rules of §§1441 and 1442
- Discussed withholding rules for four types of payments
- Discussed the filing responsibilities of a withholding agent

Resources

- www.irs.gov
- Instructions for Forms 1042 & 1042-S
- Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*
- Publication 901, *Tax Treaties*



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