An Overview of the

International Tax Withholding and Reporting Framework

By Anthony Malik, EA

It does not bear mentioning that cross-border activity is a growing dimension of both our social and business environments. With the advent of the Internet alone, it is fascinating to consider how convenient it has become to purchase goods and services from non-U.S. persons in far-flung places. As tax professionals, we are acutely aware that almost every daily-life activity is accompanied by tax consequences. In this regard, it behooves us at a very minimum to know that:

- The international activities of our clients implicate a rich body of tax laws.
- There are compliance requirements to be fulfilled in this regard.
- The failure to satisfy these statutorily imposed compliance requirements can subject our clients to penalties by the IRS.

The reporting and withholding regulations for payments to foreign persons are much more pronounced compared to payments to U.S. persons. This is because our tax policy surmises that there is a greater possibility of collection from U.S. taxpayers compared to their non-U.S. counterparts. While an extensive discussion of our tax infrastructure in this area is beyond the scope of this article, what follows is a brief survey of the U.S. international tax system, followed by an introduction to the following withholding regimes as applicable to non-U.S. individuals:

- U.S. source FDAP income
- U.S. source services income
- Foreign partners in U.S. partnerships
- Foreign Investment in Real Property Tax Act (FIRPTA)

Survey

Generally speaking, the United States taxes foreign individuals on their U.S. source income (IRC Sec. 871). However, national boundaries and other realities may make it impossible for the IRS to enforce U.S. tax laws on foreign persons. Congress deals with this potential problem by shifting the collection function onto the payers of the U.S. source income in the form of withholding and reporting requirements.

The law assigns this responsibility by characterizing the payer as a "withholding agent." A withholding agent is any person who has the control, receipt, custody, disposal, or payment of an item of a foreign person subject to withholding (Treas. Reg. Sec 1.1441-7(a)).

Additionally, a withholding agent who fails to withhold is personally held liable for the requisite tax, penalties, and interest (IRC Sec. 1461).

It should be noted that the tax code assigns these withholding and reporting responsibilities to withholding agents indiscriminately, i.e., a foreign payer of U.S. source income to a foreign payee is equally as beholden to the code's directives as a U.S. payer would be in that scenario.

Another very important aspect of U.S. tax law is that the determination of U.S. status of taxpayers is not coextensive with U.S. immigration law. Keeping with this, it is not uncommon for a foreign person, under customary immigration law, to be classified as a U.S. person under the tax law and vice versa. While this variance otherwise lends itself to some contradictory results, it is quite coherent within the contours of U.S. tax policy.

While not the subject of this article, it is important for the tax professional to be aware that U.S. or foreign status is not a simple black or white issue. Rather, residence has to be determined by considering the taxpayer's facts and circumstances within the constructs of the tax law. The tax treatment of U.S. source payments to international taxpayers can only be addressed post-residence determination. Needless to say, international taxpayers classified as U.S. persons for tax purposes are unaffected by the code's international withholding provisions. The withholding regimes discussed in the following sections are only applicable to non-U.S. (tax) persons.

U.S. Source FDAP Income

U.S. source fixed, determinable, annual, or periodic (FDAP) income to foreign persons can be thought of as

a combination of the passive and portfolio income streams to U.S. recipients. Common categories of FDAP income include interest, dividends, rents, and royalties IRC Sec. 871(a)(1)(A). FDAP income is generally subject to a flat 30 percent tax on the gross amount of the distribution IRC Sec. 871(a). The keyword is "generally" since certain exceptions may override either the 30 percent default rate or the withholding requirement entirely, including:

- provisions under domestic law
- provisions contained in international tax treaties
- incidental classification of the income as being effectively connected income (ECI)
- incidental classification of the foreign person as a U.S. person for tax purposes

Although income streams from portfolio interest, bank deposit interest, dividends, or interest from "80/20" companies, and short-term original issue discount meet the legal definition of FDAP, they are specifically exempt from withholding (but not reporting) under domestic law (Treas. Reg. Sec. 1.1441-2(a)).

Also, while the flat 30 percent tax rate on FDAP income is arguably high, the reality is that most tax treaties contain provisions proffering significant reductions to the default rate. Consider that the U.S. Model Income Tax Treaty (United States Model Income Tax Convention of November 15, 2006) makes concessions attempting to exempt interest and royalties while articulating reduced tax rates on dividends. Residents of foreign countries with which the U.S. has income tax treaties must provide a completed Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)) to the withholding agent to claim the treaty-specified exemption from, or discounted rates of, withholding prior to the receipt of payment (Treas. Reg. Sec. 1.1441-6(b)(1)).

While the flat 30 percent tax rate on FDAP income is arguably high, the reality is that most tax treaties contain provisions proffering significant reductions to the default rate.

U.S. Source Services Income

Although FDAP income includes salaries, wages, and (nonemployee) compensation for services, such income streams present an interesting case in that they are usually not treated as FDAP income for withholding purposes. This is because the type of withholding depends on the relationship of the service provider to the service recipient.

For example, regular employee withholding is required if the service provider is an employee (IRC Sec. 3401). This treatment is logically sound considering employees will typically satisfy U.S. residence provisions, thereby rendering the special withholding and reporting requirements for foreign payees inapplicable.

Payments to foreign independent contractors can produce some contradictory results. On the one hand, IRC Sec. 1441 requires the 30 percent FDAP withholding at source. On the other hand, U.S. source compensation paid for services performed outside the U.S. are exempt from U.S. taxation (Treas. Reg. Sec. 1.861-4(b)). On the third hand, notwithstanding treaty exceptions or domestic de minimis rules, the performance of personal services in the U.S. generally results in income that is "effectively connected" with the conduct of a U.S. trade or business (IRC Sec. 864(b)). ECI is taxable to the payee under a separate set of rules (IRC Sec. 871(b)) and is exempt from withholding. However, to claim exemption from withholding, the recipient must claim that the income is ECI by providing Form W-8ECI (Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States) to the withholding agent before the income is paid to the recipient.

Foreign Partners in U.S. Partnerships

In addition to the filing of an annual income tax return, a domestic partnership with foreign partners could be responsible for complying with other filing requirements. For purposes of this overview, we will limit the discussion to the two major withholding regimes that partnerships with foreign partners are subject to: the default withholding rules under Secs. 1441 and 1446.

Under IRC Sec. 1441, the domestic partnership is the withholding agent for guaranteed payments and distributive items of FDAP income to a foreign partner. To the extent a foreign partner's distributive share of income subject to withholding has not actually been distributed to the foreign partner, the U.S. partnership must withhold on the foreign partner's distributive share of the income on the earlier of the date that the partnership's annual income tax return is filed, the due date of such return, or the date by which payment is made to the foreign partner (Treas. Reg. 1.1441-5(b)(2)). Assuming that the domestic partnership timely withholds on a foreign partner's distributive share of FDAP income,

there will be no withholding obligation when the income is actually distributed to the foreign partner.

Apart from the withholding under IRC Sec. 1441, a partnership engaged in a U.S. trade or business must also withhold tax on the ECI allocable to its foreign partner (IRC Sec. 1446). The withholding under IRC Sec. 1446 is essentially an indifferent mechanism. Firstly, it is indifferent in the sense that it exists in exception to the rule exempting ECI from withholding, provided that appropriate documentation, i.e. Form W-8ECI, is presented to the withholding agent. Secondly, the partnership must report and pay this tax in advance, regardless of whether the partnership makes any distributions during its tax year and regardless of the amount of the foreign partner's ultimate U.S. tax liability. The withholding rate for a foreign partner under this code section is the highest graduated rate applicable to the partner's taxpayer type—presently 39.6 percent for individual taxpayers under IRC Sec. 1. If the amount withheld exceeds the foreign partner's ultimate U.S. tax liability, the excess is refunded.

Foreign Investment in Real Property Tax Act (FIRPTA)

In 1980, Congress enacted IRC Sec. 897, or FIRPTA. Among other things, this law requires withholding on all gains from the sale of U.S. real property by a foreign person. In general, the purchaser of any U.S. real property from a foreign seller must withhold 10 percent of the gross amount of the purchase price (IRC Sec. 1445(a)).

IRC Sec. 1445(b), in turn, provides several exceptions to the withholding prescribed under IRC Sec. 1445(a). Three of the commonly invoked exceptions include:

- When the seller provides an affidavit that he is a U.S. person (IRC Sec. 1445(b)(2)).
- When the IRS provides a statement that the seller is exempt from withholding or has made alternative satisfactory arrangements with respect to his U.S. taxability (IRC Sec. 1445(b)(4)(B)).
- When the purchaser acquires the property as a personal residence, the purchase price of which does not exceed $300,000 (IRC Sec. 1445(b)(5)).

Conclusion

There are a variety of potential tax withholding and reporting obligations imputed to withholding agents. Since withholding agents are liable to the IRS for any required withholding and are indemnified against the claims of the taxpayers, it is imperative for them to know their obligations in this regard. That said, it is equally important for tax practitioners to be aware of the pertinent laws.

Under common law, practitioners owe their clients the fiduciary duty of care. In this sense, knowledgeable advisors can protect the interests of clients transacting with non-U.S. persons. In doing so, they would be providing an invaluable service. **EA**

About the Author

Anthony Malik, EA, is the principal consultant and owner of Point Square Consulting in Atlanta, Georgia. He specializes in international taxation (individuals and businesses). Tony practices a wide range of multijurisdictional tax issues spanning across compliance, planning, and litigation support. He can be reached at tony@pointsquaretax.com.

To learn more about this topic, visit the NAEA Forums.

100% Online

Master of Science in Taxation

- Distance learning ~ No residency requirement
- No study required during the tax filing season
- Earn CPE credit
- Nationally accredited program
- Lowest tuition and fees, Maximum flexibility

The M.S.T.Program provides the conceptual understanding and technical competence advantageous for advancement in the tax consulting profession, corporate finance departments, and government tax agencies.

www.taft.edu/mst.htm

Or Call: 877-894-TAFT (8238)

William Howard Taft University
600 South Cherry Street, Office 525
Denver, Colorado 80246

William Howard Taft University