

## Internal Revenue Service

# Federal State and Local Governments: Payments to Foreign Persons

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**Val:** Welcome to this IRS Federal, State, and Local Governments Webinar Overview of Payments to Foreign Persons.

I am Valerie Hardeman and this is Bob Ching. We work with Federal, State, and Local Governments, otherwise known as FSLG.

The business unit of Federal, State and Local Governments was formed in the year 2000. We work under the Tax Exempt and Government Entities Operating Division.

What is the mission of FSLG? We provide government entities top quality customer service by helping them understand and comply with their tax responsibilities with integrity and fairness to all.

Here is what we will be covering today:

- An overview of withholding, remitting, and reporting obligations related to payments to foreign persons.
- A review of useful reference materials, including IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities and IRS Publication 519, Tax Guide for Aliens.

Let's Get Started.

We know that more and more taxpayers work in an international environment. They work with foreign employees and vendors more often than ever. International activities and accounts present unique reporting and compliance issues. The globalization of markets, taxpayers, and transactions affect all segments of the economy, including the tax-exempt sector. It is important that we all have an understanding of the basic rules and provisions governing sourcing of income and reporting requirements involving stakeholders with international implications. We want to provide you with resources to respond to this globalized environment.

Have you ever been surprised by an employee or vendor that did not have “typical” identification. For example, a foreign address, or none at all when asked for W-2 and W-4 paperwork?

It is easy to be caught off guard when a foreign person offers unfamiliar identification or documents.

Although the immigration laws of the United States use categories of immigrant, nonimmigrant and illegal alien, the tax laws refer only to foreign person, resident alien (RA), and nonresident alien (NRA).

U.S. Immigration law guides:

- The determination of residency for U.S. tax purposes.
- The determination of U.S. FICA tax liability; and
- The interpretation of some tax treaty articles.

With a number of important decisions to make in order to achieve full compliance with withholding and reporting for payments made to foreign persons, let's explore these matters in more detail.

It is important to understand that even an employer who hires illegal aliens or aliens who are working in violation of their nonimmigrant status are expected to report and withhold taxes on the payments to the aliens just as it would with respect to payments to U.S. citizens.

**Bob:** When a foreign person enters the U.S., how will they be treated for federal tax purposes?

Whether a foreign person is a immigrant, a nonimmigrant, or an illegal alien will effect their federal tax status. An immigrant has been granted the right by the U.S. Citizenship & Immigration Services (USCIS) to reside permanently within the U.S. to work without restrictions in the United States. They may also be referred to as an LPR or Lawful Permanent Resident.

A nonimmigrant may reside temporarily within the U.S. according to the terms corresponding to the visa with which they entered the United States.

An illegal alien is generally someone who has entered the U.S. without any documentation. Undocumented aliens may be deported if apprehended.

It should be noted that those who entered the U.S. legally but fall out of status with their visa may also be deported.

Remember, a U.S. employer, who hires illegal aliens or aliens who are working in violation of their nonimmigrant status, is expected to correctly report and withhold all required taxes on these wages.

Can a business entity be considered a foreign person?

Yes, because the term “foreign person” includes not only a nonresident alien individual, but also the U.S. branch of a foreign corporation, a foreign corporation or partnership, a foreign trust, a foreign estate, and any entity that is not a U.S. person as defined in the Internal Revenue Code.

This is important to understand because payments made to a foreign person, by a U.S. payer, will have different reporting or withholding requirements depending on the character of the foreign person.

As a U.S. payer, it is important to know who you are paying.

You might think that the payment of withholding taxes is the responsibility of the payee.

However, both the foreign person receiving the payment and the U.S. payer are personally responsible for the taxes on U.S. sourced income.

If the U.S. payer fails to withhold, and the foreign person does not satisfy its tax obligation, the IRS will approach the U.S. payer for any related tax liability, including interest and penalties.

Today’s webinar should help to ensure that your entity’s withholding and reporting practices are in compliance with these regulations.

By correctly withholding from payments made to foreign persons, you never need to pay taxes out of your own funds.

With proper withholding and reporting practices a U.S. payer will also avoid costly interest and penalties for failing to withhold, deposit funds, file tax returns, and/or file information returns.

As a U.S. payer, you will be required to determine the payee’s status as either a resident or nonresident filer based on the documentation provided.

The earlier you determine a foreign individual’s U.S. tax status the more likely it is that you will be successful in meeting your tax reporting obligations.

How is a nonresident alien taxed differently from a resident alien?

Generally, a resident alien is taxed in the same manner as a U.S. citizen – their worldwide income is subject to U.S. taxation.

A nonresident alien is only taxed on U.S. sourced income.

A nonresident alien is an individual who is not a U.S. citizen or a resident alien.

Certain types of U.S. source income received by a nonresident alien are subject to U.S. tax; usually at a fixed rate of 30 percent, unless a lower rate is prescribed by a tax treaty.

**Val:** What kind of documentation is required of a foreign person to verify their status within the United States?

A visa allows a nonimmigrant to enter the U.S. in one of several different categories, which correspond, to the purpose for which the nonimmigrant is being admitted to the U.S.

For example, a foreign student will usually enter the U.S. on an F-1 or J-1 visa. All visas have a time limit imposed on the holder's stay in the U.S.

A detailed discussion of visas is outside of the scope of our time today. However, we are going to outline some important characteristics so you are aware of what to look for when making payments to nonresident aliens who are employed or contracted by your organization.

Some of the common visa types are shown on this slide.

An awareness of common visas is important to employers since they are a key to accurate withholding. A visa determines appropriate taxation and income characterization for the holder.

Some visas exempt the nonresident individual from certain employment tax withholding.

For example, a teacher or trainee temporarily present in the U.S. under a "J" or "Q" visa, in compliance with the visa requirements would be exempt. A student temporarily present in the U.S. under an "F" visa could be exempt. A professional athlete temporarily in the U.S. to compete in a charitable sports event may also be exempt.

Each situation has its own parameters that should be carefully researched. Two IRS Publications; Publication 515, The Withholding Tax Guide for Nonresident Aliens and Publication 519, The U.S. Tax Guide for Aliens, offer excellent guidance when you need it. Both can be downloaded from [www.irs.gov](http://www.irs.gov).

As discussed earlier as a U.S. payer it is important to know the tax status of the individuals you hire because the withholding and reporting requirements depends on a payee's tax status.

A foreign individual that is considered a U.S. resident, or resident alien, is taxed like any U.S. citizen on their worldwide income.

A nonresident alien individual, or NRA, is generally subject to U.S. tax on only his or her U.S. source income. Certain types of U.S. source income received by a nonresident alien are subject to U.S. tax at a flat rate of 30 percent; unless a lower rate is prescribed by a tax treaty.

A foreign individual may become a resident alien by either having a green card or passing the substantial presence test.

A foreign person who is a lawful "immigrant" of the United States under the immigration laws of the United States – has met the green card test.

An "immigrant" is defined as a foreign individual who has been granted the right, by the U.S. Citizenship & Immigration Services, to reside permanently, and to work without restrictions within the U.S.

All lawful immigrants are eventually issued a "green card" (Form I-551) and immigrants who are awaiting the issuance of their green card may bear an I-551 stamp in their foreign passports.

Bob: The "substantial presence test" is a two-part test that uses a foreign individual's days of physical presence in the United States as the basis for determining whether a foreign individual should be treated as a resident alien for US tax purposes.

The two parts of the substantial presence test are a 31-day and a 183-day requirement.

If both parts of the substantial presence test are met, the foreign individual is treated as a resident alien.

The 31-day requirement is met if the foreign individual is physically present in United States for 31 days during the year under consideration.

The 183 day requirement is met if the sum of:

- The number of days in the U.S. for the current year, plus
- 1/3 of the number of days in the U.S. for the first preceding year, plus
- 1/6 of the number of days in the second preceding year total an amount greater than or equal to 183 days.

It is important to remember that any portion of a day is considered a full day for purposes of this test.

However, under certain circumstances days of physical presence may not be counted. For example, you do not count the days when a foreign individual is present in the U.S. as a "teacher" or "trainee" under a valid J or Q visa.

For more examples of “days” that should not be counted for purposes of the test, see Publication 519, regarding the Substantial Presence test under “Days of Presence in the United States.”

Let’s consider a foreign individual, Maria, who has been visiting the U.S. for the past three calendar years.

As you can see, her three-year travel history shows that she spent 122 days in 2010, 119 days in 2009 and 136 days in 2008.

By applying the appropriate multiplier:

- 1 - to the current year (2010);
- 1/3 to the FIRST preceding year (2009); and
- 1/6 to the SECOND preceding year (2008)

And adding up their products, we see that Maria has met the substantial presence test because she has spent more than 183 days within the U.S. over the past three years, and has spent at least 31 days in the current year.

Resident aliens and nonresident aliens can receive income as individuals, employees and independent contractors.

Remember resident aliens are individuals who have a green card or have met the substantial presence test. As a consequence they are taxed on their worldwide income just like any U.S. citizen.

Nonresident Aliens are individuals who have not met the substantial presence test, and are taxed only on their income from U.S. sources.

The next issue for a nonresident alien is whether the U.S. source income is subject to withholding taxes or reporting requirements. The answer to that question is dependent on the nature of the income.

What is U.S. sourced income and how is it taxed when it is or is not considered income effectively connected to a U.S. trade or business?

Generally, income is considered U.S. sourced income if it is paid by a domestic corporation, a U.S. citizen, a resident alien or an entity formed under the laws of the United States.

If the property that produces the income is located in the U.S. or if the services for which the income is paid were performed in the U.S. the income is considered U.S. sourced income.

Some examples of income that may be from sources within the U.S. include:

- Compensation for personal services
- Interest and dividends
- Pensions and annuities
- Rental income
- Royalties
- Taxable scholarship and fellowship grants
- Other taxable grants, prizes and awards

The Internal Revenue Code sourcing rules are contained at sections 861 through 865.

Remember: income tax treaties can modify these rules.

**Val:** If these same income items are non-business in nature the payments are generally subject to withholding.

Tax must be withheld on a gross basis at a 30 percent rate unless it is effectively connected to a U.S. trade or business.

This non-business income is commonly referred to as “fixed or determinable, annual or periodic income” – or FDAP income.

Certain types of interest are exempt from the 30 percent tax and capital gains are generally not taxed.

If you are a U.S. withholding agent for such payments, you must collect, deposit and report the income and the withholding taxes to the IRS.

In certain instances, the 30 percent withholding rate may also be reduced if there are other statutory rates (see Publication 515) or the item paid is to a foreign resident covered by a tax treaty that provides for a lower rate.

However, if the U.S. source income paid to a foreign person is determined to be from the conduct of a trade or business within the United States it is considered “effectively connected income” (ECI).

Effectively connected income is subject to the graduated income tax rates applicable to U.S. persons and not the 30 percent withholding rate. A foreign person receiving effectively connected income is required to file a U.S. income tax return because they are conducting a trade or business within the United States.

When payments are deemed to be effectively connected income, the U.S. payer, or withholding agent, has reporting requirements as opposed to a withholding obligation.

Therefore, a U.S. withholding agent must consider two categories of payments to foreign persons in determining its compliance responsibilities to the IRS:

- Payments that are U.S. source non-business income (that is Fixed or Determinable, Annual or Periodic - also known as FDAP) are subject to withholding taxes; and
- Payments that are related to a trade or business activity in the United States or Effectively Connected Income (ECI) are taxed at graduated rates.

If a foreign person is engaged in a trade or business in the US, income that would normally be deemed non-business FDAP income may become effectively connected income if:

- The income is derived from assets used in or held for the use in the conduct of that trade or business; or
- The activities of that trade or business in the US are a material factor in the realization of that income.

Hence, rather than being subject to a 30 percent withholding tax, the non-business FDAP income would be combined with the ECI income and taxed at the regular graduated tax rates.

An example of applying the Asset Use Test:

If the foreign person receives a payment for interest related to an “account receivable” from the U.S. business activity, the interest payment would be treated as ECI and not FDAP income.

**Bob:** A U.S. withholding agent must be able to identify all non-U.S. citizens and nonresident payees in order to meet its withholding responsibilities

Are you a withholding agent under the Code?

You are a withholding agent if you have control, receipt, custody, or payment of any item of income belonging to a foreign person that is subject to withholding.

A withholding agent is often described as the last person in the United States who has control over the money before it is paid to the foreign person.

The term “withholding agent” includes, but is not limited to individuals, U.S. corporations, foreign intermediaries, and U.S. branches of a foreign entity.

A withholding agent is personally liable for any taxes that were required to be withheld.

What is the potential cost of not compiling with these withholding regulations?

Aside from owing the amount of tax that should have been withheld and interest, a withholding agent can face such civil penalties as:

- The 100 percent penalty equal to the total amount of tax evaded;
- The 20 percent accuracy-related penalty of the amount of the underpayment of withheld tax in the case of negligence;
- A 75 percent penalty for the underpayment of withheld taxes in the case of civil fraud;
- Additional taxes of five percent to a maximum of 25 percent for the negligent failure to file a return; and
- Additional taxes of 15 percent to a maximum of 75 percent for the fraudulent failure to file a return.

Obviously, the reporting of these payments is very important.

Let's move on to understanding how some of the common visas mentioned earlier are handled for employment tax purposes.

U.S. employers need to properly identify payments that require different withholding calculations, tax deposits and reporting requirements.

**Val:** Some of the more common visas seen by educational institutions are F-1, J-1 and M-1 visas.

Other visa types that are commonly seen include;

The H-1b for specialty occupations such as teachers, trainees and researchers; and H-1c for foreign nurses.

The O-1 visa is issued to foreign scholars, teachers, researchers or trainees, and the TN is issued to foreign scholars, teachers, researchers or trainees arriving from Canada or Mexico under a NAFTA treaty.

A withholding agent should know that each visa type can have different social security, Medicare and income tax withholding requirements. Let's examine a few of the visa types previously mentioned to illustrate this point.

Visa types F-1, J-1, M-1, Q-1, and Q-2 wages are exempt from social security and Medicare as long as the holder is a "non-resident alien".

H-1b, H-1c, O-1, and TN visas are subject to social security and Medicare taxes whether the holder is a resident or nonresident alien.

**Bob:** F, J, M, Q, H, O and TN visas assigned to a resident alien are subject to special instructions but are generally taxed under the same graduated rate as U.S. citizens.

Scholarship and fellowship payments made to foreign individuals holding these visas may be subject to a variety of different treatments such as;

- A graduated rate subject to special instructions for payment for services
- No withholding if the payment is a qualified scholarship under section 117;
- Fourteen percent withholding on non-service income;
- Or a lower rate specified under a tax treaty, unless the entire payment is exempt from taxes.

As you can see, a withholding agent needs to be familiar with the status of each foreign individual and vendor before payments are ever made.

Now, let's consider the common situation of a foreign individual who is an employee of a U.S. employer.

**Val:** Normally, the first time an employer becomes aware that a worker may be a nonresident alien is when the individual submits documentation and identification for I-9 and W-4 purposes.

Once foreign workers are identified on the payroll the employer should divide these workers into two groups: Resident aliens and Nonresident aliens.

Resident aliens are generally subject to the same tax treatment as U.S. citizens, subject to all social security, Medicare, and federal income tax withholding.

Nonresident aliens are subject to additional withholding and reporting rules specific to their unique status as a foreign worker.

Generally, the wages of nonresident alien workers are also subject to Social Security, Medicare and Federal income tax, but there are exceptions.

A common exception is a nonresident alien employee who claims that he or she is exempt from employment taxes because of a tax treaty.

If a foreign worker claims a tax treaty exemption from Social Security and Medicare, the foreign individual must complete a Form 8233, Exemption From Withholding on Compensation, for the U.S. employer. The employee is to complete and provide a Form 8233 with respect to the income that is exempt under a tax treaty. Publication 515 identifies countries that have treaties with the United States.

All compensation not exempt under the tax treaty will be subject to employment taxes in conjunction with the nonresident alien's Form W-4, which is also subject to special adjustment, for the applicable number of withholding allowances claimed.

A nonresident alien who fails to file a valid Form W-4 should have federal income taxes withheld at the rates pertaining to an individual who is single status and zero withholding allowances.

Even if a nonresident alien employee submits a Form 8233, it is a good business practice to secure a Form W-4 from the employee and withhold accordingly until the submitted Form 8233 is not rejected by the IRS.

A final word of warning: Do not equate a foreign individual's "residence" with "citizenship." Just because an individual has a passport from a particular foreign country does not mean that he or she is a legal resident of that country under the laws of that country or under a tax treaty. Residency is usually defined in an article of a tax treaty and it does not follow the provisions of the Internal Revenue Code.

It is possible for a foreign worker with a passport from Germany, to claim to be a resident of France and subject to the provisions of the U.S.-France Tax Treaty.

**Bob:** What should a U.S. employer do when receiving documentation and paperwork from a nonresident alien who has not satisfied all of the requirements of the W-4?

Remember: A nonresident alien who fails to file a valid Form W-4 must have federal income taxes withheld at the single status, zero withholding allowances rates.

U.S. employers should advise nonresident aliens to review IRS Notice 1392, Supplemental Form W-4 Instructions for Nonresident Aliens, before completing the Form W-4.

U.S. employers should know that nonresident aliens

- Cannot write "exempt" on line 7 of the Form W-4; and
- May only claim "single" for their filing status on line 3 of Form W-4, regardless of their actual marital status.
- With limited exceptions, a nonresident alien cannot claim more than one withholding allowance on their W-4.
- And, finally, they are required to write "Nonresident Alien" or "NRA" above the dotted line of line 6.

**Val:** How does a U.S. employer calculate the amount to be withheld for a nonresident alien?

Because the wage withholding tables are designed for U.S. citizen employees, a standard deduction amount is built into the calculation.

Because a nonresident alien employee is not entitled to the standard deduction, use of the tables for a nonresident alien would result in under-withholding on income tax calculations unless an adjustment is made.

To solve this problem, the IRS introduced a gross-up procedure for payroll processing effective January 1, 2006.

There are two steps required to calculate how much income tax to withhold from the wages of a NRA. Publication 15 provides a chart showing the additional amount to be added to wages for calculating income tax withholding on individuals not eligible for the standard deduction.

The first step is to add the adjustment found in Pub. 15 to the amount of wages paid to the nonresident alien employee.

The second step uses the adjusted amount from Step 1 and the number of withholding allowances claimed (usually limited to one allowance) on the W-4 to figure out the withholding from the tables used for all employees.

- If you use the percentage method tables reduce the amount figured in Step 1 by the value of the withholding allowances and apply that reduced amount to the table.
- If you use the wage bracket tables use the amount figured in Step 1 and the number of withholding allowances to determine the income tax withholding.

Don't forget, as of January 1, 2011, all deposits of withheld taxes must be made electronically.

A unique exception to the "Special Steps" for U.S. employers in calculating the federal income tax withholding on nonresident alien individuals is Article 21 of the U.S.-India Income Tax Treaty.

Nonresident alien students and business apprentices from India are not subject to the chart-based additions procedure we just discussed.

**Bob:** The employer should explain to their nonresident alien employees that the amounts added under the chart are solely for the purpose of calculating federal income tax withholding and nothing else.

- The chart amounts are not included in any box on the employee's Form W-2;
- They do not increase the Federal income tax liability of the employee;

And, do not increase the Social Security or Medicare tax liability of the employer or the employee.

Remember that some nonresident alien employees are eligible for exemptions from federal income tax withholding on some or all of their wages because of a tax treaty.

To claim an exemption under a tax treaty, the nonresident alien individual must file a Form 8233 with their employer.

Are there other exceptions to the withholding rate for nonresident aliens?

Of course.

We don't want to forget Totalization Agreements.

These agreements are like tax treaties, but are between the Social Security Administration and various foreign countries.

The agreement is to address a situation where dual Social Security taxation occurs when a foreign employee is working within the United States and required to pay these taxes to both the U.S. and the NRA's country of residence on the same wages.

Totalization agreements must be honored by a U.S. employer.

The foreign worker who claims an exemption under a totalization agreement needs to provide the U.S. employer with a certificate of coverage from the resident country that will be collecting the taxes.

The U.S. employer should keep a copy of the certificate in the event the IRS questions why FICA taxes are not being withheld.

More information on totalization agreements are available in Section 7, Page 21 of 2011 IRS Publication 15-A, and at [www.socialsecurity.gov/international](http://www.socialsecurity.gov/international).

**Val:** Foreign students, teachers or trainees with specific visas are not subject to U.S. social security and Medicare taxes on pay for services performed within the U.S. as long as such services are allowed by their visa status and performed to carry out the purpose for which the alien was admitted to the U.S.

It is important to remember that under this exception, the wages earned by the foreign student, teacher or trainee remain subject to income taxes. They are only exempt from Social Security and Medicare withholding.

U.S. employers might wonder "What forms do I need to use to report this withholding, or why am I not required to withhold?"

So far, we have been focusing on an employment relationship with nonresident alien status. We will talk about vendor or independent contractor payments later. For now, remember that resident alien and nonresident alien employees' wages are reported on the Forms 941 or 944 and W-2 in the same manner as your normal payroll reporting.

However, when the wages for a nonresident alien are exempt under a tax treaty those payments are reported on Forms 1042 and 1042-S. We will cover these payments in greater detail later.

When should the tax be withheld & deposited?

Withholding is required at the time that the payment is made. A payment is considered to be made when the recipient of the payment realizes the income. There does not need to be a transfer of cash or other property.

The frequency of deposits is determined by the amount of tax that the U.S. withholding agent is required to withhold.

Publication 515 details the specific rules including due dates, which forms to use, electronic deposit requirements, and penalties for failure to make deposits timely.

Any additional wages paid that are not exempt under a tax treaty must be reported on Forms 941 or 944 and W-2 in the usual manner.

As a U.S. employer you must not forget your state reporting obligations.

A form W-2 is usually required to report state and local wages and income taxes withheld even in situations in which all of a nonresident alien's wages are exempt from federal income tax under a treaty, and all federal wages would be reported on Form 1042-S.

A tax treaty only applies to the Federal tax regime and not state taxes. There are no tax treaties between a foreign government and a state.

**Bob:** What are some of the ways a U.S. payer can identify vendors subject to the special foreign reporting and withholding requirements?

- Consider the use of a non-U.S. address;
- Look for missing information in the Address, City, State, Zip, and Country fields of a completed W-9; or other forms that might be used in your internal vendor set-ups.
- Look for a foreign Employer Identification Number. For example, EINs that are issued to foreign entities usually begin with the digits "98".
- Also, see if the vendor has an Individual Taxpayer Identification number (or ITIN); ITINs begin with "999" and the fourth digit is generally a 7 or an 8. (999-7/8x-xxxx)

"ITINs" are issued to foreign individuals who are required to have an identification number for U.S. tax purposes. They generally do not have, and/or are not eligible to obtain a social security number. The Form W-7 is used by the foreign individual to apply for an ITIN.

By being familiar with these clues and number configurations you will be able to recognize unusual or non-conforming information provided by a worker or vendor.

What is the next step?

Generally, a U.S. payer must withhold 30 percent of any payment to a foreign person unless they can reliably associate the payment with documentation that:

- Establishes the payee is a US person;
- Claims a reduced rate or exemption with a valid and properly completed series W-8 form (e.g. a -BEN, -ECI, -EXP or -IMY);

Or

- Establishes that the payee is covered under a tax treaty with an accepted Form 8233.

When should the tax be withheld?

Withholding is required at the time that the payment is made. A payment is considered to be made when the beneficial owner of the payment realizes the income. There does not need to be a transfer of cash or other property.

Remember: only U.S. source FDAP income is subject to withholding.

- Interest is U.S. sourced, if the debtor is a U.S. resident.
- Rents and royalties are U.S. sourced, if the property is used or located in the U.S.
- All personal services performed in the U.S. are generally U.S. sourced.

If there is any uncertainty about whether the payment is U.S. source income, review all applicable documentation.

Always consider the type and nature of the income paid.

For example, when payments are for services, invoices and related documentation such as engagement letters and contracts should be reviewed to determine whether any of the services are performed within the United States.

If the source cannot be determined, the payment should be treated as U.S. source by default.

**Val:** Do I need any identification from a foreign vendor?

Resident Aliens who are recipients of U.S. sourced income from independent personal services are treated as U.S. persons and Form W-9 should be secured.

For individuals, the TIN on Form W – 9 is generally a Social Security Number. However, in some cases, an Individual Taxpayer Identification Number (or ITIN) may be used. Review the instructions for the Requester of Form W-9 to be sure.

Nonresident Alien individuals or foreign vendors that are not considered a U.S. resident or a U.S. entity must provide a Form W-8. In some cases, where a tax treaty applies, Form 8233 is also required.

Once foreign vendors and U.S. sourced FDAP payments are determined, how much should be withheld from payments?

The statutory withholding rate for foreign persons is generally 30 percent. This rate should be applied to the gross amount of the payment and withholding is collected at the time of payment to the foreign vendor.

In some cases, the foreign vendor is a resident in a country that has a tax treaty with the United States.

Each tax treaty has specific provisions to determine the withholding rate. These provisions reduce the withholding rate based on the type of income and the status of the recipient. Refer to [www.irs.gov](http://www.irs.gov) to retrieve a copy of Publication 515 for a listing of tax treaties and the withholding tax rates to be applied to the various types of income under each treaty.

The foreign vendor must provide the withholding agent with a properly completed Form W-8 and Form 8233 if tax treaty benefits are claimed. Any time an exemption amount is claimed from withholding, the documentation must be validated and in the possession of the withholding agent at the time of payment. We will examine the forms requirements in detail later.

**Bob:** All foreign vendors should be required to submit a Form W-8 as soon as possible. Foreign vendors being paid for the first time should be required to present a completed Form W-8 before any payment is made.

Remember a U.S. withholding agent must have documentation from the foreign vendor to certify its non-U.S. status, and its eligibility for either reduced withholding or full exemption under a tax treaty.

Acceptable documentation may be in the form of a series W8 form or Form 8233. The series W-8 forms include:

- W-8 BEN and
- W-8 ECI

Foreign persons should use the Form W-8BEN

- To establish that the payee is not a U.S. person;
- To claim that the payee is a beneficial owner of the income for which the W-8BEN is being provided;

- To claim a reduced rate or exemption as a resident of a foreign country with a tax treaty on income that is not personal services income.

Remember: A completed Form W-8BEN is not always used to claim a reduced withholding rate or exemption from withholding. It can be used just to establish the fact that the payee is not a U.S. person.

Form W-8BEN should not be used by a nonresident alien individual who claims exemption from withholding on compensation for independent or dependent personal services performed within the U.S.

The Form 8233 is the appropriate document under such circumstances.

**Val:** The W-8ECI is to be used by a foreign person to claim exemption from withholding when the payee has effectively connected income.

The form W-8ECI cannot be used by a nonresident alien individual with personal service income.

A valid form W-8ECI must include a U.S. TIN or it is invalid. A U.S. TIN is defined as a social security number, employer identification number or IRS individual taxpayer identification number (ITIN).

What is the significance of the Individual Tax Identification Number (or ITIN)?

The ITIN is issued to individuals who are required for U.S. tax purposes to have a U.S. tax identification number but do not have and are not eligible to obtain a social security number.

If you recall, a nonresident alien individual who is not eligible for a social security number may have an ITIN' beginning with 999 and the fourth digit is a 7 or an 8.

The Form W-7 is used to apply for an ITIN.

Forms W-8BEN and W-8ECI that do not have a U.S. TIN will remain in effect from the date the form is signed and ending on the last day of the 3rd succeeding calendar year received unless a change in circumstances makes any information on the form incorrect.

For example, if the form was received on September 30, 2010, it will remain in effect until December 31, 2013.

Form W-8BEN with a U.S. TIN will remain in effect until a change in circumstances makes any information on the form incorrect, provided the withholding agent reports on Form 1042-S at least one payment annually to the beneficial owner who provides the W-8BEN form.

Foreign persons who provide certain series W-8 forms are exempt from backup withholding and Form 1099 reporting.

**Bob:** Remember a US withholding agent must withhold at 30 percent unless the payment can be associated with a document to support lower rates or exemption from withholding.

The Code requires that the document offered by the foreign persons be valid in order to be relied upon by the withholding agent.

If the withholding agent cannot reliably associate a payment with valid documentation, the agent must use the “Presumption Rules” provided in the Code.

If the withholding agent complies with the Presumption Rules he will not be liable for tax, interest, or penalties even if the rate of withholding that should have been applied ... based on the payee’s actual status is different from that presumed and withheld.

The Presumption Rules apply to the determination of

- The status of the person you pay;
- Whether the payee is a beneficial owner or intermediary;
- Whether the payee is a individual, corporation, partnership, or trust.

Discussions of these rules are beyond the time limitations of this presentation.

Please see Publication 515 for more information including a chart of the specific regulations and the particular Presumption Rule in the absence of documentation.

All forms, their instructions, and publications are readily available at [www.irs.gov](http://www.irs.gov).

**Val:** Form W-8ECI should be used by a foreign vendor to certify that the payment is income that is effectively connected with a U.S. trade or business. No withholding is required on such income - because that income should be reported on the foreign vendor’s U.S. business’ income tax return.

The Form 8233, Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual, is used by a NRA to claim a tax treaty exemption from withholding of taxes.

The form is used to claim a withholding exemption on some or all income from independent contractor services, wages, personal services income and non-compensation scholarship or fellowship income.

Also, the Form 8233 is used to claim a personal exemption amount to reduce independent personal services income. This form generally requires a SSN, however, an ITIN may be used.

To claim a tax treaty exemption the NRA provides three copies of the Form to the U.S. payer, that is the withholding agent.

The U.S. withholding agent should review and sign the certification in Part IV if he or she is satisfied that the claim is correct.

The U.S. withholding agent then mails one copy of the Form with all attachments submitted by the nonresident alien individual to the IRS within five days of receipt of the claim.

After mailing the Form to the IRS, the U.S. withholding agent must wait at least 10 days to see if the IRS has any objections. If the U.S. withholding agent is later notified by the IRS with objections to the NRA's claim, the agent must begin withholding immediately.

Form 8233 must be completed by the nonresident alien individual and filed by the U.S. withholding agent annually.

**Bob:** A nonresident alien who is paid for independent services that are not exempt from withholding will be subject to 30 percent withholding on that compensation after subtracting the value of the allowable personal exemptions.

Generally, a nonresident alien is allowed a single personal exemption.

However, residents of Canada, Mexico, or South Korea, a student or business apprentices from India, and U.S. nationals, are generally entitled to claim additional exemptions.

In such cases, the allowable personal exemption is to be prorated for the number of days during the tax year the personal services were performed in the U.S. See the Special Instructions to the Form 8233 for more information on the computation of withholding on certain independent personal services.

**Val:** The final payment for compensation during the tax year for independent personal services may be entirely or partly exempt from withholding. In order to determine the exemption amount the nonresident alien must file specific information with the IRS.

IRS Publication 519 describes the process for the final payment exemption.

After filing, a letter will be sent from the IRS to the nonresident alien but addressed to the payer/U.S. withholding agent showing the amount of the final payment that is exempt from withholding and the final amount that can be paid to the alien.

The NRA must provide the payer/withholding agent with two copies of the letter. This exemption is available only once during the tax year and applies to a maximum of \$5,000 in compensation.

**Bob:** Withholding agents will report payments to foreign persons of U.S. sourced FDAP income and/or income generally subject to withholding using the Forms:

- 1042,
- 1042-S,
- and 1042-T.

The Form 1042, Annual Withholding Tax Return for U.S. Source income of Foreign Persons, is submitted to the IRS to report the total aggregate of NRA payments, withholdings, and deposits made by the US withholding agent during the year.

A U.S. withholding agent must file a Form 1042 if:

- You are required to file Form 1042-S (whether or not any tax was withheld or was required to be withheld), or
- You pay gross investment income to foreign private foundations that are subject to tax under section 4948(a) of the Code.

File only one Form 1042, consolidating all information from the foreign recipient's Form 1042-S, regardless of the number of different recipients, branches, divisions, or types of income for which you are the withholding agent.

The frequency of your deposit requirements are determined by the amount of tax that is required to be withheld.

See Publication 515 for the specific rules for the Form 1042, including due dates, which forms to use, electronic deposit requirements, and penalties for failure to make deposits timely.

Do not attach paper Forms 1042-S with your Form 1042.

The Form 1042-S is filed separately with the 1042-T.

The Form 1042-S, Foreign Person's U.S. Source Income subject to withholding, is an information return.

It is important to note that there is no minimum amount that triggers the filing requirement for a 1042-S. All payments should be reported.

This form is required even if the entire amount of compensation is exempt under a tax treaty.

Use the Form 1042-S to report payments that are:

- exempt under a tax treaty,
- compensation for personal services performed in the US,

- scholarships, fellowships, grants, or financial aid paid to nonresident aliens that are not a “qualified scholarship,”
- and rents.

A separate form is required for each foreign recipient who receives such income.

And withholding agents filing paper forms must use a separate Form 1042-S for the specific type of income.

Form 1042-T, Annual Summary and Transmittal of Forms 1042-S, should be used to transmit the paper Forms 1042-S to the IRS.

**Val:** We’ve learned more about these topics today:

- Globalization
- The importance of U.S. Immigration law
- Resident and nonresident alien tax status
- U.S. Sourced income
- The different withholding rules in the case of:
  - FDAP or ECI income
  - Nonresident alien individuals as an employee or independent contractor
  - Forms W-4, 8233 and the W-8 series
  - Forms 1042, 1042-S and 1042-T

Use IRS publications 515, 901, and 519 help to ensure your organization is in compliance with its obligations related to Payments to Foreign Persons and visit our website at [www.IRS.gov](http://www.IRS.gov) under the Government Entities tab.

A list of additional sources is available at the end of the PDF version of the slides, available on this site.

This concludes our webinar on Payments to Foreign Persons. Thank you for attending today’s session.

We value your comments and encourage your feedback on this webinar.

Please send your comments to: [tege.fslg.feedback@irs.gov](mailto:tege.fslg.feedback@irs.gov) .

If you have Federal Tax topics for government entities that you would like to hear about on future webinars, please provide your comments at the same email address.

If this presentation has provided you with helpful information, please tell us as well as others! Do join us for future events.

For more information, we encourage you to contact the FSLG specialist in your state.

On behalf of the Internal Revenue Service, thank you for watching this program.

Enjoy the rest of your day.