

NRA Withholding and Reporting on Payments to Foreign Nationals

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The federal withholding and reporting rules for payments for personal services made to foreign nationals depend on the recipient's federal tax residency status – resident alien or nonresident alien.

Compensation payments to resident aliens are subject to the same rules for withholding and reporting as are such payments to U.S. citizens. These payments are not subject to withholding generally. However, if the recipient failed to provide you with a U.S. taxpayer identification number, or the IRS notified your organization that the recipient is subject to backup withholding you must backup withhold, currently at 28 percent. If the total payment equals or exceeds \$600 in the tax year, or the amount was subject to backup withholding, or both, you must report the amount and taxes withheld, if any, on Form 1099-MISC, box 7. Payers who withheld and reported taxes must also submit a Form 945 tax return.

If the recipient is a nonresident alien and the compensation payment is U.S.-source income, you must withhold 30 percent (called "NRA withholding") unless an exception applies. In order to exempt a payment from withholding, the payment must meet the specific conditions for the exception and the recipient must provide any paperwork required for the exception prior to the payment. The payment and taxes withheld, if any, must be reported on a Form 1042-S under Income Code 16 unless the compensation is for a performing artist or athlete. The Income Code for compensation paid to a performer is either 42 (compensation not covered by a Central Withholding Agreement) or 43 (compensation covered by a CWA). Payers who submit one or more Forms 1042-S must also submit a Form 1042 tax return even if none of the payments were subject to withholding.

If your organization is a withholding agent and failed to withhold the proper tax, the organization will be liable for the underwithheld tax plus penalties and interest. There are penalties that apply for failure to report the income, as well.

How do I know if my organization is a withholding agent?

IRS defines "withholding agent" very broadly. Every U.S. or foreign person who controls, holds custody of, receives, disposes of, or pays any item of income to a foreign person that is subject to NRA withholding is a withholding agent.

A withholding agent includes (without limitation) individuals, corporations, partnerships, trusts, associations, or any other entity including individuals or entities acting as agents or intermediaries.

Your organization is a withholding agent even if there are other organizations or individuals who meet the definition of withholding agent as to an income payment. If more than one person is a withholding agent as to a single payment, the total withholding should not exceed 30 percent. When there are several withholding agents with regard to a single payment, they all have joint and severable liability.

How will I know the tax residency status of the recipient?

You need to collect from each recipient who will be paid by your organization either a Form W-9 as a certificate of U.S. status or a Form W-8BEN as a certificate of foreign status. This withholding certificate also serves as proof of solicitation of a U.S. taxpayer identification number – a U.S. social security number (SSN) or individual taxpayer identification number (ITIN). You may accept the withholding certificate as proof of status as long you (or anyone in your organization) does not know or have reason to know that the recipient's status is not consistent with the form presented.

These forms should be requested from the individual at the time that the arrangement for the services is entered into. If the recipient is a foreign national, you also will need to collect information about the recipient's immigration status and days of presence in the United States in this tax year and two prior tax years to determine the recipient's tax residency status. This is especially important for any recipient who wishes to claim a tax-treaty exemption from tax because resident aliens may not claim treaty benefits for self-employment income.

Do the same tax residency rules apply for state withholding tax purposes?

No, unless the state has specific rules defining residency that are tied to a recipient's federal tax residency status. Lacking such special rules, residency for state tax purposes is determined for foreign nationals under the same rules that apply to U.S. citizens.

What if I have no information when I have to make a payment?

The Section 1441 regulations provide presumptions that you must follow in order to avoid liability for underwithholding when you make payments to recipients for whom you have no documentation. (See the table in IRS Publication 515 for references to specific withholding regulations for different types of payments.)

An individual recipient on whom you have no information is presumed to be a U.S. person (i.e., a U.S. citizen or resident alien). Therefore, if you have no documentation, you must impose 28 percent backup withholding on the payment and report the payment and taxes on Form 1099-MISC.

However, if you or anyone in your organization knows or has reason to know that the recipient is a foreign national who might be a nonresident alien, you must withhold the higher 30 percent tax and report the income and taxes withheld on Form 1042-S.

What would give me reason to know that the recipient is a nonresident alien?

IRS has addressed the facts that would cause a payer who has no actual information about a recipient to have a reason to know that the recipient might be a nonresident alien.

- The individual is not a U.S. citizen or immigrant (popularly called a “green-card holder”). A nonimmigrant is a U.S. person only if substantially present in the United States under the 183-Day Substantial Presence Test.
- The individual has not provided a U.S. Social Security number (SSN). U.S. citizens and green-card holders may obtain an SSN. However, nonimmigrants with work authorization may obtain an SSN whether they are resident aliens or nonresident aliens.
- A recipient has an individual taxpayer identification number (ITIN). An individual not eligible to obtain an SSN may obtain an ITIN for a federal tax administration purpose such as submitting a U.S. tax return or claiming a treaty-exemption from tax. Possession of an ITIN does not mean that a recipient is a resident alien since anyone with a federal tax administration purpose, including foreign nationals outside the United States, may obtain an ITIN.
- The recipient has a foreign address. U.S. citizens and residents living abroad will have a foreign address as well as nonresident aliens. A U.S. citizen or green-card holder may rebut this presumption by presenting you with proof of U.S. status such as a U.S. passport or Form I-551 (evidence of green-card status) respectively.
- The payment is being transmitted to a foreign financial account. A recipient who has a U.S. SSN whose payment is being sent to a foreign account might be a nonresident alien. The SSN might have been issued long ago when the individual was authorized to work in the United States.

For more information about what the IRS looks for in a 1042 audit of accounts payable, see IRM 4.10.21 Examination of Returns, U.S. Withholding Agents, Examinations Form 1042. http://www.irs.gov/irm/part4/irm_04-010-021.html

What if the service provider wasn't authorized under the immigration rules to provide the services?

You must apply the proper withholding and reporting rules based on tax residency status to payments to foreign national recipients regardless of whether the recipient was authorized to provide the services or not. It is the provision of services by an unauthorized individual that is a violation of the immigration laws. However, your organization's payment to the individual and reporting document (and the recipient's resulting tax return) is evidence of that unauthorized service.

If your organization knowingly used the services of an unauthorized individual, immigration law converts this individual to your employee for employment sanction purposes.

Does the recipient have to provide an SSN or ITIN in order to be paid?

No, there is no federal law or regulation that requires that an income recipient provide you with an SSN or ITIN in order to be paid. In fact, you must make the payment if you have an agreement with the recipient obligating your organization to pay the amount.

An SSN or ITIN is needed in two situations:

1. For a claim under an income tax treaty provision for exemption from tax on any amount other than investment income on publicly traded investments.
2. For reporting income and taxes withheld, if any.

Not all reporting requires an SSN or ITIN. For example, no SSN or ITIN is required to be reported on a Form 1042-S if tax was withheld at the statutory rate. The statutory rate is 30 percent for compensation for self-employment services as well as for most other payments.

How do I find out if the payment is U.S.-source income?

The source of income is determined under U.S. tax rules based on the type of income. Compensation for personal services, whether employment or self-employment, is generally sourced where the services are performed, not where the income is paid. Therefore:

- Income for services performed outside the United States is foreign-source and not subject to U.S. tax for a nonresident alien, even if paid by a U.S. employer or payer.
- Income for services performed in the United States is U.S.-source income and subject to U.S. tax even if paid by a foreign employer or payer.

If you have no information about where an income payment is sourced, you must presume that the amount is U.S.-source income and withhold and report accordingly.

There are also special sourcing rules for types of payments related to personal services.

- A covenant (i.e., a promise) not to compete is sourced where the right is given up.
- A signup bonus is sourced where the employment to which the bonus relates is sourced. See Rev. Rul. 2004-109, I.R.B. 2004-50.

For the IRS overview of more sourcing rules, see Types and Sources of Income.

Also, see IRS Publication 519, U.S. Tax Guide for Aliens, Section 8, for more detailed information about source of income.

Do I have to withhold on payments for services performed abroad?

Compensation for services performed abroad is foreign-source income. For audit purposes, the place where the services are performed should be indicated in the agreement with the individual. It is not sufficient that the location where the services performed is indicated on the invoice since this is considered by the IRS to be a self-serving statement.

If you have a Form W-8BEN as a certificate of foreign status (no TIN required) from the service provider, and the location of the services is documented, you do not have to withhold U.S. tax on the compensation payments. You are also not required to report on the income. You may, however, report the income on a Form 1042-S under Exemption Code 03 (foreign-source income).

Even without the Form W-8BEN, you are not required to withhold or report on compensation for services performed abroad if you have no actual knowledge or no reason to know that the recipient of the service provider is a either a U.S. citizen or resident alien or that the income was effectively connected to the conduct of a U.S. trade or business.

You may have withholding or reporting obligations, or both, in the country where the services are provided.

What if the payment includes both U.S.-source and foreign-source income?

If you know that the payment includes both U.S.-source and foreign-source income, and you do not have a reasonable allocation of the U.S.-source amount, you must treat the entire amount as U.S.-source.

The recipient of the income can submit a U.S. tax return with an allocation of the income between U.S. and foreign sources and can obtain a refund of any overwithheld taxes.

What if the recipient of the income has requested that payment be made to a third party?

If a third party has been designated to receive the payment for services, whether you still have to withhold on and report the income as if made to the individual who provided the services depends on the circumstances.

- If the arrangement for the services was made with the service provider who, after the services were performed, indicated that payment should be made to his or her corporation (called "assignment of income" in case law), you must continue to treat the payment as if made to the service provider.
- If the third party is merely acting as an agent of the service provider, you must withhold and report the

payment as if made directly to the service provider.

- If the facts support that the third party is the foreign employer of the service provider, you still must withhold 30 percent if you are not satisfied that the foreign employer is complying with U.S. payroll tax and income reporting rules. In this situation, you would treat the third party as the beneficial owner of the income, however, not the service provider.

Where the relationship between the service provider and the third party is not clear, you must withhold 30 percent on the payment and report the income in the name, Unknown Recipient. In this case, however, neither the payee nor the beneficial owner of the income will be able to apply the withheld amount to their U.S. tax obligation computed on their U.S. tax return.