



# U.S. WITHHOLDING TAXES FOR PAYMENTS TO FOREIGN PERSONS



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## Introduction

Whilst the United States ("U.S.") taxes its citizens, residents, and domestic corporations on their worldwide income, nonresident individuals and foreign entities (collectively, foreign persons) are generally taxed on only four categories of income:

1. Fixed or determinable annual or periodical ("**FDAP**") income from U.S. sources, such as U.S.-source interest, dividends, rents, royalties, wages, etc.<sup>1</sup>;
2. Income effectively connected with a trade or business in the U.S. ("**ECI**") or, if a tax treaty applies to the nonresident individual or foreign entity, income attributable to a permanent establishment in the U.S.<sup>2</sup>;
3. Income derived from the disposition of a U.S. real property interest under the Foreign Investment in Real Property Tax Act of 1981 ("**FIRPTA**")<sup>3</sup>; and
4. Certain income of a foreign financial institution that does not satisfy reporting and other requirements under the Foreign Account Tax Compliance Act ("**FATCA**")<sup>4</sup>.

The U.S. may impose a tax on a foreign person without legal jurisdiction over that foreign taxpayer sufficient to fully enforce compliance with such taxes. To address this jurisdictional issue and encourage voluntary compliance, the U.S. has legislated withholding tax procedures, which require the U.S. payor (or certain foreign intermediaries) to withhold taxes, remit the taxes to the U.S. Treasury, and report information with respect to the withholding to the Internal Revenue Service ("**IRS**").

When a U.S. individual or entity transacts with a foreign person, it is important for both parties to understand whether the U.S. withholding taxes apply and, if so, what is required to stay compliant and prevent costly penalties.

The Internal Revenue Code includes four principal withholding tax regimes for cross-border transactions and investments.<sup>5</sup> These withholding tax regimes are the following:

1. FDAP Withholding (Chapter 3)<sup>6</sup>;
2. Partnership ECI Withholding<sup>7</sup>;
3. FIRPTA Withholding<sup>8</sup>; and
4. FATCA Withholding (Chapter 4).<sup>9</sup>



<sup>1</sup>I.R.C. §§ 871(a), 881(a).

<sup>2</sup>I.R.C. §§ 871(b), 882, 875.

<sup>3</sup>I.R.C. § 897.

<sup>4</sup>I.R.C. §§ 1471-1474.

<sup>5</sup>Other withholding regimes in the Internal Revenue Code include backup withholding, I.R.C. § 3406, wage withholding, I.R.C. §§ 3401, 3402, and withholding on payments to foreign tax-exempt organizations, I.R.C. § 1443. These withholding tax regimes are outside the scope of this whitepaper.

<sup>6</sup>I.R.C. §§ 1441, 1442.

<sup>7</sup>I.R.C. § 1446.

<sup>8</sup>I.R.C. § 1445.

<sup>9</sup>I.R.C. §§ 1471 et seq.

In general, before concluding that withholding tax does not apply to a payment to a foreign person, the U.S. payor (called the “withholding agent”) must review the rules for each type of withholding tax regime to confirm that none of them applies to the payment at issue. This whitepaper discusses the general rules under each regime, however, it does not include a discussion of the rules on certain exceptions or special transactions.

## FDAP Withholding (Chapter 3)

A foreign person is subject to a 30% withholding tax on their U.S.-source FDAP income. The withholding tax liability may be reduced or eliminated pursuant to an in-force tax treaty of the U.S., though reporting of the withholdable payment may nonetheless be required. FDAP income from U.S. sources includes fixed or determinable annual or periodical gains, profits and income, especially:

- Dividends of a U.S. corporation;
- Interest paid by a U.S. resident;
- Rents on property located within the U.S.; and
- Royalties for intangible property used in the U.S.

Under the FDAP withholding rules, “all persons, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment” of any U.S.-source FDAP income of a foreign person is required to withhold taxes from such income items. A person required to withhold the taxes is referred to as the “withholding agent.”



If a withholding agent fails to withhold and remit the proper amount of taxes on FDAP payments directed outside of the U.S., the withholding agent becomes liable for the under-withheld and unremitted taxes, interest if the taxes are remitted late, and, potentially, various penalties.

Presumption rules essentially require that a withholding agent assume a full 30% withholding tax applies to any U.S.-source FDAP payment *unless* the withholding agent can, prior to the payment, reliably associate the payment with valid documentation of the counterparty's status, including, for example, what type of person or entity the counterparty is, whether the counterparty is domestic or foreign, and whether a tax treaty applies to reduce or eliminate the withholding tax.

In general, a foreign person certifies their status by providing the withholding agent with Form W-8BEN (for an individual), W-8BEN-E (for an entity), W-8IMY (for a pass-through intermediary entity or certain branches), or Form W-8EXP (for certain foreign government, international organization, or tax-exempt entities). A domestic person generally certifies their status by providing the withholding agent with Form W-9.

Taxes withheld under Chapter 3 must be deposited in a designated financial institution and remitted to the U.S. Treasury. Although the deadline for remitting taxes depends on the amount of withholding tax, the deadline to remit is generally soon after the taxes are properly withheld—typically on a monthly or quarter-monthly basis.

By March 15 of each year, the withholding agent must file Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, to report information about U.S.-source FDAP payments made to foreign persons during the prior year and the taxes withheld and remitted with respect to such payments. In addition to Form 1042, a Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, must be filed by March 15 of each year to report information about withholdable payments and withholding taxes with respect to each foreign recipient.

## Partnership ECI Withholding

A partnership with a U.S. trade or business (or U.S. permanent establishment, if a treaty applies) must withhold and remit taxes on a foreign partner's share of the partnership's income effectively connected with the U.S. trade or business (or income attributable to the permanent establishment). The required rate of withholding is generally the highest ordinary tax rate for individuals (currently 37.5%) for noncorporate partners or the highest rate for corporations (currently 21%) if the foreign partner is a corporation.



In addition to partnership withholding on annual ECI attributable to foreign partners, a foreign partner's disposition of an interest in a partnership with a U.S. trade or business (or permanent establishment) is treated as giving rise to ECI and the transferee must withhold and remit 10 percent of the amount realized on the disposition of the partnership interest.

A partnership may generally rely on a properly completed withholding certificate (W-8BEN, W-8IMY, W-8ECI, W-8EXP, or W-9) provided to it by the partner in determining which of its partners are foreign or domestic.

Failure to withhold or remit taxation under the partnership ECI withholding rules results in the general partners of the partnership being jointly and severally liable for under-withheld taxes, interest, and penalties.

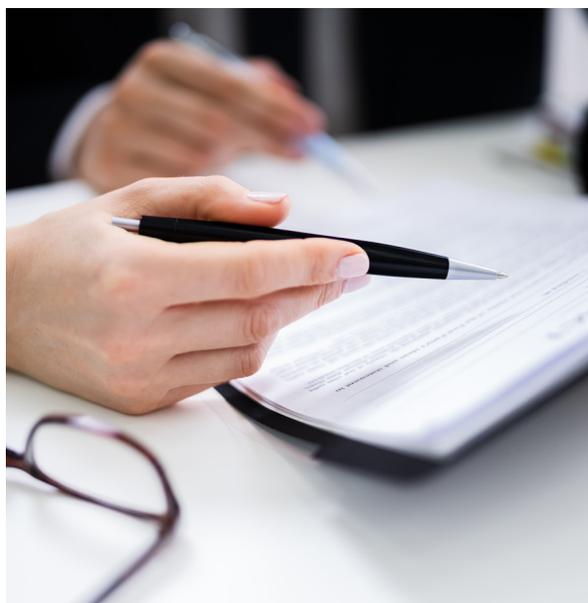
A partnership with ECI must make quarterly installment payments of the partnership ECI withholding taxes on its foreign partners and report to such partners the amount of taxes paid. The partnership files Form 8813 with its quarterly estimated payments of partnership ECI withholding taxes.

Annually, a partnership that has foreign partners and ECI must file Forms 8804 and 8805 to report information with respect to the share of ECI allocable to foreign partners and the partnership ECI withholding taxes paid and remitted. A copy of Form 8805 must be provided to each respective foreign partner to report the amount of tax withheld on such foreign partner.

## FIRPTA Withholding

When a foreign person disposes of a U.S. real property interest, the transferee is generally required to deduct and withhold 15 percent of the gross proceeds from the disposition. A U.S. real property interest includes property physically located in the U.S., which is of any of the following types:

1. Land;
2. Unsevered natural products of the land;
3. Improvements, structural components of buildings, and inherently permanent structures;
4. Certain personal property associated with the use of real property; and
5. Interests, other than solely as a debtor, in domestic corporations that are or have been within the 5-year period ending on the date of the disposition, a U.S. real property holding corporation. A U.S. real property holding corporation is a domestic corporation if the fair market value of U.S. real property interests is at least 50 percent of the fair market value of all real property interests and other trade or business assets held by the corporation.



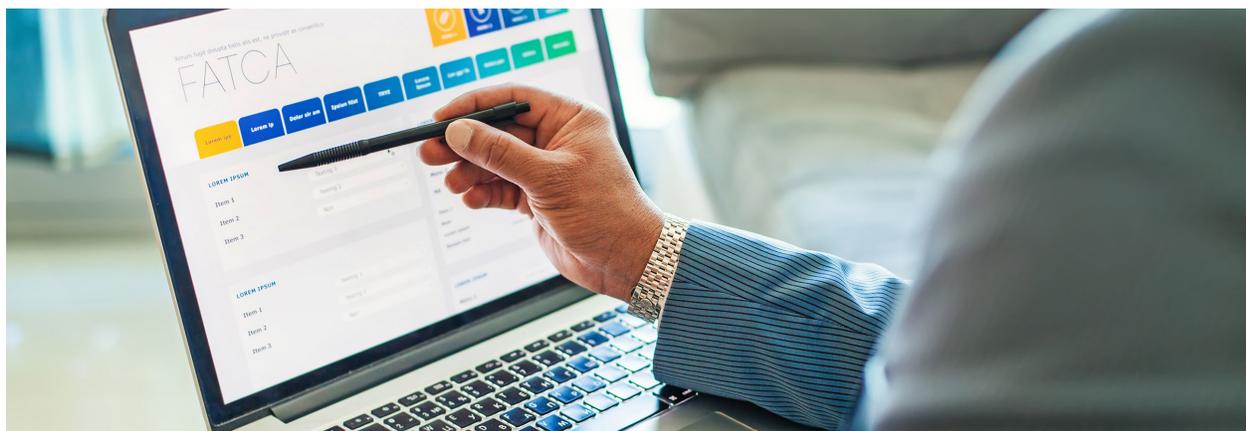
FIRPTA withholding rules may also apply to distributions by current or former U.S. real property holding corporations to foreign shareholders or a foreign person's disposition of an interest in a partnership that has U.S. real property interests.

A transferee of a U.S. real property interest may protect itself from liability for penalties for failure to properly withhold under FIRPTA rules by either (1) obtaining a nonforeign affidavit stating that the transferor is *not* a foreign person (under penalties of perjury) or (2) by properly ascertaining that the property transferred is *not* a U.S. real property interest. Shares in a domestic corporation are presumptively U.S. real property interests unless the transferee obtains from the transferor certain documentation certifying that the shares are not U.S. real property interests (i.e., that the corporation is not and has not been for five years to the date of the transfer, a U.S. real property holding corporation).

Generally, a transferee required to withhold under FIRPTA must report and remit the withheld taxes by the 20th day following the date of transfer. The tax is remitted along with a completed Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and a Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*.

## FATCA Withholding (Chapter 4)

Under FATCA, a “withholding agent” who makes a “withholdable payment” to a foreign financial institution (“FFI”) or non-U.S. entity that is not an FFI (i.e., “NFFE”) not satisfying certain reporting and other requirements with respect to U.S. owned accounts and substantial U.S. owners under Chapter 4 must withhold 30% from such payment.



Generally, a withholding agent is any person having control, receipt, custody, disposal, or payment of a withholdable payment. However, FATCA excludes individuals from being considered withholding agents (unless the payment in question is made during the individual's trade or business).

A “withholdable payment” generally includes FDAP income (dividends, interest, rents, royalties, salaries, wages, annuities, etc.) but also includes gross proceeds from the disposition of stock or debt that would produce U.S.-source dividends or interest.

A withholding agent must generally presume that the 30% withholding under Chapter 4 applies to a withholdable payment (i.e., as if the payee is a nonparticipating foreign financial institution) *unless* the withholding agent reliably associates the payment with a valid form of documentation (typically Form W-9 or the applicable Form W-8). A foreign payee certifies their Chapter 4 status<sup>10</sup> to the withholding agent on the appropriate Form W-8, which the withholding agent may generally rely on in determining the amount of Chapter 4 taxes, if any, that must be withheld.

Like Chapter 3 reporting, Forms 1042 and 1042-S are required to report the withholding taxes under Chapter 4 on annual basis.

## Conclusion and Take-aways

The withholding tax rules are lengthy and complex. They can also pose pitfalls and traps for the unwary.

The first step to prevent costly mistakes around withholding taxes is to understand the basics of when they might apply and to establish procedures to ensure cross-border transactions are compliant with the procedural and reporting requirements.

Another important way that U.S. multinationals can reduce withholding tax risks is to obtain and keep on file up-to-date Forms W-8 and W-9 from the individuals and entities with whom they transact, including vendors, partners, and shareholders. A U.S. person can generally rely on these documents to certify the payee's or transferor's entity type, tax residency, FATCA status, applicability of a tax treaty, and other relevant characteristics for application of the withholding tax rules.

For many U.S. companies with international transactions or investors, advance planning around withholding taxes can go a long way towards identifying opportunities for better tax efficiency or to mitigate risks of unexpected taxes, interest, and penalties. Whether a cross-border supply chain, an upcoming distribution to investors, or a possible M&A transaction, companies could benefit from early consideration of the withholding tax rules.

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*This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please consult with your advisors for specific advice.*

<sup>10</sup> "The term chapter 4 status means a person's status as a U.S. person, a specified U.S. person, an individual that is a foreign person, a participating FFI, a deemed-compliant FFI, a restricted distributor, an exempt beneficial owner, a nonparticipating FFI, a territory financial institution, an excepted NFFE, or a passive NFFE." Treas. Reg. § 1.1471-1(b)(19).



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