

AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

# BDO KNOWS: INTERNATIONAL TAXATION



## ► SUBJECT

### U.S. WITHHOLDING ON PAYMENTS TO FOREIGN PAYEES

## ► AFFECTING

Every United States person that makes payments of fixed or determinable annual or periodical (“FDAP”) income (*e.g.*, dividends, interest, royalties, and certain payments for non-dependent personal services) to nonresident aliens, foreign partnerships, foreign corporations, and nonresident aliens or foreign fiduciaries of estates or trust “foreign persons.” The term “payments” includes U.S.-sourced amounts allocated to such foreign partners on partnership Schedules K-1 (Form 1065).

## ► DETAILS

Generally, every United States person that makes payments of FDAP income to foreign persons is required to withhold the proper amount of United States income tax and timely remit any amounts withheld to the Service.

The general statutory withholding tax rate in the United States on FDAP income is 30 percent. However, the rate of withholding tax may be reduced under a tax treaty between the United States and the resident country of the recipient, provided certain treaty limitations of benefits and United States compliance requirements are met.

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## OVERVIEW OF THE WITHHOLDING RULES

A United States payor of FDAP income should obtain either Form W-9, Request for Taxpayer Identification Number and Certification, or one of the forms in the W-8 series, from the beneficial owner of the income to establish whether or not the beneficial owner is a foreign person. If no such form is furnished, backup withholding is required. The beneficial owner is the person who ultimately receives the financial benefit of the payment; generally flow-through entities are not beneficial owners.

A 30-percent withholding tax applies to payments of FDAP income to foreign persons unless documentation is provided allowing for a reduced withholding rate under a United States income tax treaty. If foreign taxpayers seek to rely on a treaty for reduced withholding, they must provide Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding, to the withholding agent (or fund) in order to claim a reduced rate of withholding tax on the payment under a tax treaty. Form W-8BEN is kept on file with the withholding agent to document that a treaty applies to the particular payment, the foreign recipient is the beneficial owner of the income, and the payor qualifies under the applicable treaty for a reduced withholding tax rate. Form W-8BEN also requires a United States taxpayer identification number for the foreign payee. Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding, or 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, may be required instead of Form W-8BEN, depending on the identity of the beneficial owner. If a Form W-8IMY is furnished from a flow-through entity that is not a withholding agent, the associated W-8 or W-9 forms from the beneficial owners should be transmitted with the Form W-8IMY.

The W-8 series forms are generally valid until December 31 of the third year after issuance. Prior to such expiration date, new Forms W-8BEN, W-8IMY, and W-8ECI must be furnished by a payee to the payor, if a change in circumstances makes the originally-provided information incorrect.

If payments of FDAP income are made to foreign persons, the proper amount of withholding tax should be withheld from the payment and remitted to the Service. United States withholding tax remittances must be made through electronic deposit. The timing and frequency of any required remittance are determined by the amount of the remittance. The instructions to Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and IRS Publication 515, Withholding of Tax on Nonresident Aliens and Foreign Entities, provide guidance on the remittance requirements. It is important to be in compliance with the various requirements applicable to withholding agents. The Large Business and International Division of the Service has identified withholding and reporting on FDAP income as a Tier 1 audit examination issue.

If it is discovered that the withholding agent has withheld too much tax, there are generally three alternatives to recover the over-withholding. First, the foreign beneficial owner can file a United States tax return (generally Form 1040NR for an individual and Form 1120-F for a corporation) and claim a refund for the amount of tax that exceeded the required withholding. Second, the withholding agent can use its own funds to repay the beneficial owner the amount over-withheld. This must be done by March 15 of the year following the year of the over-withholding. The withholding agent can then reimburse itself by reducing subsequent deposits that are made before the end of the year. Third, the beneficial owner can be made whole through under-withholding on a subsequent payment, thereby offsetting the prior over-withholding. For this option, the subsequent payment must be made before March 15 of the year following the withholding or the date the Forms 1042-S, Foreign Person's U.S Source Income Subject to Withholding, are actually filed, whichever is earlier. The Form 1042 instructions provide additional guidance with respect to the treatment of any over-withholding.

## OVERVIEW OF THE REPORTING REQUIREMENTS

United States taxpayers must use Form 1042 to report annually the tax withheld during the year on certain FDAP income paid to foreign persons. This reporting is required on a calendar-year basis regardless of the taxable year of the taxpayer. Form 1042 should be filed with the Service by March 15 of the year following the year of the payment. If additional time is needed, Form 7004, Application for Extension of Time to File Certain Business Income Tax, Information, and Other Returns, may be filed to extend the filing date but not the payment of tax.

In conjunction with Form 1042, Form 1042-S must be filed on annual basis. Form 1042-S applies where the United States taxpayer made payments to foreign persons that are subject to withholding tax, even if no amount was deducted and withheld from the payment because of a treaty or Internal Revenue Code exception or if any amount withheld was repaid to the payee. The filing deadline for Form 1042-S is March 15 of the year following the year of the payment. To request an extension of time to file Form 1042-S, Form 8809, Application for Extension of Time to File Information Returns, may be filed no later than the due date for filing Form 1042-S. This application will provide an automatic 30-day extension. If additional time is needed, a second 30-day extension may be requested, but is not automatically granted. If more than 250 Forms 1042-S are being filed, electronic filing is mandatory.

Finally, Form 1042-T, Annual Summary and Transmittal of Forms 1042-S, must also be filed on an annual basis if Forms 1042-S are being filed on paper. This form is used to transmit the Forms 1042-S to the Service. The filing deadline for Form 1042-T is also March 15.

Special rules apply if a United States partnership has foreign partners. United States partnerships that generate FDAP income are required to withhold on their foreign partners' distributive share of the FDAP income. If, in a particular year, a United States partnership generates FDAP income but does not distribute that income, no tax liability should be reported on the Forms 1042 for that calendar year. However, if the income is distributed in the following year, it should be reported on the date of the distribution. Additional guidance is provided in the Form 1042 instructions.

Withholding agents that do not withhold the required amount of tax may be subject to various penalty and interest provisions under the Code. Such penalties can be significant in relation to the amount of tax that should have been withheld on payments of FDAP income. Failure to file Form 1042 (and related forms) can also subject the withholding agent to penalties.

Withholding agents should review all payments to foreign payees in 2010 and complete the Form 1042 filing requirements by March 15, 2011. Withholding agents should also review the documentation that has been provided to them with respect to any reduced withholding claimed by the payees on such payments. Failure to file Forms 1042 or to withhold and remit the proper amounts can subject the withholding agent to significant penalties.

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