# TAX MANAGEMENT
# PORTFOLIOS™

## FOREIGN INCOME

# International Aspects of U.S. Income Tax Withholding on Wages and Other Compensation for Services

by

John L. Harrington
Dentons USA LLP
Washington, DC

John L. Harrington, J.D., Columbia Law School (1987); B.S. University of Florida (1984). Chair of Dentons' U.S. Tax practice. Mr. Harrington advises clients on tax planning, transactional and compliance issues; international tax legislative, regulatory, and treaty matters; and a variety of substantive and legislative domestic tax issues. He has extensive experience in dealing with the foreign tax credit, anti-deferral regimes (including Subpart F income), cross-border activities of companies and individuals, and other international tax issues. Prior to joining Dentons, Mr. Harrington served as International Tax Counsel for the U.S. Department of Treasury, where he worked closely with the Internal Revenue Service to develop regulations and other administrative guidance and represented the United States at tax-related meetings of the Organisation for Economic Co-operation and Development (OECD) and in tax-related trade disputes before the World Trade Organization (WTO). Before joining the Treasury Department, Mr. Harrington was a tax counsel on the U.S. House Committee on Ways and Means.

This Portfolio revises and supersedes previous versions of 6820 T.M., *International Aspects of U.S. Income Tax Withholding on Wages and Other Compensation for Service*.



ISBN 978-1-61746-986-2

BLOOMBERG TAX
makes available the following professional resources:

U.S. INCOME PORTFOLIO SERIES
MEMORANDUM
ESTATES, GIFTS AND TRUSTS PORTFOLIO SERIES
ESTATES, GIFTS AND TRUSTS JOURNAL
FOREIGN INCOME PORTFOLIO SERIES
INTERNATIONAL JOURNAL
COMPENSATION PLANNING JOURNAL
REAL ESTATE JOURNAL
TAX PRACTICE SERIES
FINANCIAL PLANNING JOURNAL
IRS PRACTICE ADVISER
ACCOUNTING POLICY & PRACTICE REPORT
ACCOUNTING PORTFOLIO SERIES
TRANSFER PRICING REPORT
STATE TAX PORTFOLIO SERIES
WEEKLY STATE TAX REPORT

For information, call 1-800-372-1033
Visit our website at: https://pro.bloombergtax.com







ISBN 978-1-61746-986-2

# TAX MANAGEMENT
# PORTFOLIOS™

FOREIGN INCOME

# International Aspects of U.S. Income Tax Withholding on Wages and Other Compensation for Services

## PORTFOLIO DESCRIPTION

Tax Management Portfolio, *International Aspects of U.S. Income Tax Withholding on Wages and Other Compensation for Services*, No. 6820, describes the U.S. wage withholding rules that apply to nonresident individuals working in the United States, and to U.S. citizens and tax residents working in foreign countries. Also discussed are the rules regarding the 30% U.S. withholding tax on U.S.-source compensation for services paid to self-employed nonresident alien individuals, and U.S. information reporting requirements concerning wages and compensation for services paid to employees and self-employed individuals in an international context.

Generally, wage withholding is not imposed on compensation paid to an employee who is a nonresident alien for services performed outside the United States, but wage withholding may apply (subject to numerous special rules) if the employee performing services outside the United States is a resident alien or a U.S. citizen.

In the case of compensation for services paid to a self-employed nonresident alien individual, withholding is generally required only in the case of compensation paid to nonresident aliens with respect to services rendered within the United States. A number of special exceptions may apply, however. In the case of compensation for services fees paid to self-employed individuals who are resident aliens or U.S. citizens, withholding is required only in the case of "backup" withholding.

This portfolio may be cited as Harrington, 6820 T.M., *International Aspects of U.S. Income Tax Withholding on Wages and Other Compensation for Services*.





ISBN 978-1-61746-986-2

# TABLE OF CONTENTS





ISBN 978-1-61746-986-2

ISBN 978-1-61746-986-2

ISBN 978-1-61746-986-2

ISBN 978-1-61746-986-2

# DETAILED ANALYSIS

## I. Introduction

### A. *In General*

The U.S. tax system has long used withholding at source to enforce collection of a taxpayer's federal income tax liability. This is particularly true in two principal areas:

(1) tax withheld at source by employers from the wages of employees (often referred to hereinafter simply as wage withholding tax);[1] and

(2) tax withheld on U.S.-source fixed or determinable annual or periodical income (FDAP) paid to nonresident alien individuals and foreign corporations, usually at a 30% rate.[2]

Although the amount of tax withheld may differ from the taxpayer's actual substantive tax liability on the underlying income as determined at the end of his or her taxable year, withholding of tax at source permits a tax authority to collect tax revenue on a preliminary basis from categories of persons who might not pay their full tax liability on a voluntary, self-assessment basis. This could occur in the case of employees who might otherwise have difficulty setting aside sufficient funds periodically to pay their tax. In the case of foreign persons, the withholding mechanism collects the tax due from persons who are outside the jurisdiction of U.S. courts and who might not pay their tax even if they had no difficulty in setting aside the necessary funds.

In other cases, however, Congress has determined that the administrative problems of requiring withholding would be too burdensome. Thus, as a general rule no withholding is required in the case of payments made to self-employed individuals who are U.S. citizens or resident aliens, nor is withholding required in the case of compensation for services paid to U.S. corporations or foreign corporations engaged in business in the United States. Withholding is required, however, in the case of compensation for services performed within the United States by self-employed nonresident aliens, although this requirement may be relieved pursuant to an income tax treaty. In many cases in which withholding tax at source is not required, the Code requires that an information return describing the payment be furnished to the IRS to assist it in collecting the payments that are required to be made on a self-assessment basis by the recipient. The "backup withholding" system of §3406 also exists so as to ensure that some tax is paid by individuals not otherwise subject to withholding tax but who fail to give a proper social security number to a payor.

### B. *Scope of this Portfolio*

This Portfolio examines the U.S. tax withholding and reporting rules on wages and other compensation for services paid in a cross-border context — primarily to individuals who are not U.S. tax residents working in the United States and U.S. citizens and tax residents working abroad.

The Portfolio's focus is on individuals who provide services, either as an employee or as a self-employed person, and who move or travel from their "home country" to work (either temporarily or permanently) in another country, one of which is the United States. For this purpose, the term "home country" refers to the jurisdiction where the individual resides (or resided prior to leaving) for tax purposes, and the term "host country" refers to the jurisdiction where he or she is temporarily working. Thus, the scope covers an individual who would be classified as a nonresident alien who works temporarily in the United States, whether the individual was sent by his or her employer (or client or customer) to do so or because the employee chose or needed to work in the United States during a short-term stay in the United States.[3] The scope also covers individuals who are U.S. citizens or resident aliens and who are sent by their employer (or customer or client) to perform services in another country or who choose or need to work in a foreign country during a short-term stay. Further, because the United States taxes U.S. citizens regardless of where they reside, the scope includes U.S. citizens who consider a foreign country their "home country" and who visit the United States to work for only temporary periods of time. Similarly, it covers individuals who are classified as resident aliens, but who move from the United States to a foreign country and who may thereby lose their resident alien status but who nevertheless consider their absence from the United States to be only temporary.

The withholding and reporting rules that apply to individuals working within the United States differ from those that apply to individuals working outside the United States. As a general rule, the U.S. rules on wages paid to employees and compensation for services paid to self-employed individuals apply on a territorial basis to most payees (whether U.S. citizens or other tax residents) who work within the United States. With respect to individuals working outside the United States, however, U.S. withholding and reporting apply in most cases only if both the payor and the payee have some nexus with the United States. As discussed in VI., below, however, there are gaps in the law that impose withholding on U.S. citizens and resident aliens working outside the United States even though the employer may have no nexus whatsoever with the United States. In practice, it is difficult for the IRS to enforce the law as written in those situations.

[1] §3401–§3404. All section references are to the Internal Revenue Code of 1986 (the Code), as amended, and the regulations thereunder unless otherwise indicated.

[2] §1441–§1464.

[3] For example, an individual might be a "digital nomad" who performs services remotely and prefers to live in various locales. Alternatively, an individual might have to interrupt a vacation to work on a project or, for medical or family reasons, need to remain in the host country longer than expected.



ISBN 978-1-61746-986-2

In discussing the U.S. withholding and reporting rules that apply in a cross-border context, this Portfolio discusses three categories of individuals:

(1) U.S. citizens;

(2) resident aliens; and

(3) nonresident aliens.

The format of this Portfolio assumes that in most cases an individual is "based" either in the United States or in a foreign country. Sections II. and III. discuss the general withholding and reporting rules that apply to employees and to self-employed individuals. Sections IV. and V. discuss the wage withholding rules that apply to all three categories of individuals (U.S. citizens, resident aliens, and nonresident aliens) who work as employees primarily within the United States (even though they may sometimes perform services outside the United States). Sections VI. and VII. then discuss the wage withholding rules that apply to these three categories of employees when they are based in a foreign country (even though they may sometimes perform services inside the United States). Sections VIII. and IX. then discuss the withholding and reporting rules that apply to these three categories if they work primarily in the United States as self-employed individuals, and sections X. and XI. discuss the three categories if they work primarily in a foreign country as self-employed individuals. As noted above, the terms "home country" and "host country" will be used occasionally, where appropriate.

The final two sections deal with compliance-related issues: special computational problems (section XII.) and the tax payment and filing procedures for both employees and self-employed individuals, and for the persons who make payments to them for services (section XIII.).

### C. *Status as a U.S. Citizen, Resident Alien, or Nonresident Alien*

#### 1. *Federal Income Tax Distinction Between U.S. Citizens and Resident Aliens*

For most federal income tax purposes, there is no difference between a citizen and resident of the United States.[4] In certain instances, however, the reporting or withholding requirements discussed in this Portfolio differ, at least as a technical matter, depending on whether an individual is a citizen or a resident alien. Accordingly, this Portfolio distinguishes between U.S. citizens and U.S. resident aliens and notes when the rules may differ.[5]

#### 2. *Status as a Resident Alien or a Nonresident Alien*

Generally, an individual who is not a U.S. citizen is considered a resident of the United States, or a "Resident Alien," in any calendar year that the individual:

(i) is a lawful permanent resident of the United States at an time during such calendar year (a "green card holder"),

(ii) meets the "substantial presence test" of §7701(b)(3), or

(iii) makes the first-year election described in §7701(b)(4).[6]

"Nonresident aliens" make up the residual category. Nonresident aliens are all individuals who are neither U.S. citizens nor resident aliens (as defined in §7701(b)(1)(A).[7]

Income tax treaties have their own definition of "resident" and typically include "tie-breaker" rules to determine how to address an individual who is treated as a resident of both treaty partners.[8] The treaty definition and tie-breaker may affect an individual's tax liability, e.g., by limiting source-country taxation, but they do not override domestic rules outside the coverage of the income tax treaty. Accordingly, an individual may be treated as a resident of only one country under the income tax treaty but still subject to reporting and other rules of both countries under their domestic laws. Note also that the treaty tie-breaker rules have limited effect on U.S. citizens. The United States traditionally retains its power to tax its citizens as though the treaty did not enter into force, except in certain identified areas, through a "saving clause."[9]

[4] See, e.g., §7701(a)(30) ("The term 'United States person' means (A) a citizen or resident of the United States.…").

[5] For a detailed discussion of the U.S. citizenship rules and the expatriation rules concerning loss of U.S. citizenship, *see* 837 T.M., *Non-Citizens — Estate, Gift, and Generation-Skipping Transfer Taxation* (Estates, Gifts and Trusts Series).

[6] §7701(b)(1)(A).

[7] §7701(b)(1)(B).

[8] *See* Article 4 of the U.S. Model income tax convention, the OECD Model income tax convention, and the United Nations income tax convention.

[9] See, e.g., paragraphs (4) and (5) of Article 1 of the U.S. Model income tax convention. For more information regarding treaty tie-breaker rules, *see* 6870 T.M., *U.S. Income Tax Treaties — Provisions Relating Only to Individuals.*



ISBN 978-1-61746-986-2

### *D. Summary of Withholding and Reporting Consequences*

| | | Services Performed Inside United States | | Services Performed Outside United States | |
|---|---|---|---|---|---|
| | | U.S. Payor of Compensation | Foreign Payor of Compensation | U.S. Payor of Compensation | Foreign Payor of Compensation |
| U.S. Citizens | Employee | Generally subject to reporting and withholding under §3402. *See* II., IV.A. | Generally subject to reporting and withholding under §3402. II., IV.A. | Need to check specific rules. *See* II., IV.B., VI.A. | Need to check specific rules. *See* II., IV.B., VI.A. |
| | Self-Employed | Generally Form 1099 reporting only if payor is a business and no withholding (other than backup withholding) *See* III., VIII. | Generally Form 1099 reporting only if payor is a business and no withholding (other than backup withholding) *See* III., VIII. | Need to check specific rules. *See* III., X. | Need to check specific rules. *See* III., X. |
| Resident Aliens | Employee | Subject to treaty benefits, generally subject to reporting and withholding under §3402. *See* II., IV.A. | Subject to treaty benefits, generally subject to reporting and withholding under §3402. *See* II., IV.A. | Need to check specific rules. *See* II., IV.B., VI.B. | Need to check specific rules. *See* II., IV.B., VI.B. |
| | Self-Employed | Generally Form 1099 reporting only if payor is a business (and no exception applies) and no withholding (other than backup withholding) *See* III., VIII. | Generally Form 1099 reporting only if payor is a business (and no exception applies) and no withholding (other than backup withholding) *See* III., VIII. | Need to check specific rules. *See* III., X. | Need to check specific rules. *See* III., X. |
| Nonresident Aliens | Employee | Generally subject to reporting and withholding under §3402 but check exceptions. *See* II., V. | Generally subject to reporting and withholding under §3402 but check exceptions. *See* II., V. | Generally not subject to reporting and withholding under §3402. *See* II., VII. | Generally not subject to reporting and withholding under §3402. *See* II., VII. |
| | Self-Employed | Generally subject to reporting and withholding under §1441 but check exceptions. *See* III., IX. | Generally subject to reporting and withholding under §1441 but check exceptions. *See* III., IX. | Generally not subject to reporting and withholding under §1441. *See* III., XI. | Generally not subject to reporting and withholding under §1441. *See* III., XI. |



ISBN 978-1-61746-986-2

## II. U.S. Income Tax Withholding and Reporting on Employees — General Structure

### *A. General Statutory Requirements*

Section 3402(a)(1) requires "every employer" that pays "wages" to deduct and withhold tax at source in accordance with detailed regulations and withholding tables. The term "wages" is defined in §3401(a) as "all remuneration … for services performed by an employee for his employer," subject to a number of specifically enumerated exceptions. Section 31.3401(c)-1 provides a definition of "employee," and §31.3401(d)-1 provides a definition of "employer." Numerous court decisions and IRS rulings also address these definitional issues in specific factual situations.

Furthermore, the IRS will frequently rule on whether a particular individual (or class of individuals) is an "employee" for wage withholding tax purposes, as well as for FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Taxation Act) purposes, where application for a ruling is made on IRS Form SS-8.[10]

The regulations indicate that an employer-employee relationship exists "when the person for whom services are performed has the right to control and direct the individual who performs the services." Other factors indicative of employee status are that the individual is furnished with tools and with a place to work, such as office space on the premises of the person receiving the benefit of the services. However, a number of other factors may be considered in a particular factual situation by the IRS or by the courts in ruling on this question.[11]

As a general rule, the determination of whether an employment relationship exists is made based on the actual facts, and cannot be changed by an election or putative agreement of the participants. Thus, if an employment relationship exists, the employer and employee cannot elect out of the relationship; the employee can only be classified as a self-employed independent contractor if the circumstances of their relationship are changed so that he or she ceases in fact to be an employee. In the absence of such a change, compensation for services paid to the employee will usually be classified as "wages" on which the employer must withhold. Similarly, a self-employed individual and the person for whom he or she performs services cannot elect to treat him or her as an employee unless, on the basis of the facts, he or she actually is an employee.

*Comment:* Although technically a self-employed individual may not be classified as an employee, in many cases the IRS might not object even if it learns that the individual is being treated improperly as an employee. The usual concern with misclassification of a worker is that employment-related taxes will not be paid or will be paid only at a much later time. Improper treatment of an independent contractor as an employee flips that concern: wage withholding taxes on an employee will usually be paid more rapidly than estimated quarterly tax payments by an independent contractor, and social security taxes would often be paid faster than the social security self-employment tax that an independent contractor would pay (and sometimes even increased). An employer is also required to pay FUTA tax and state unemployment taxes on wages paid to an employee, whereas independent contractors are exempt from FUTA tax on their self-employment income.

If an individual is classified as an "employee" for wage withholding purposes, he or she will usually be classified as an employee for FICA and FUTA tax purposes as well. However, it is advisable to check the FICA and FUTA definitions of "employer" and "employee," which sometimes differ slightly from the wage withholding definitions, as well as any further distinctions among the three taxes in the respective definitions of covered employment.

For further details on the general structure of the wage withholding rules, *see* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

Because the wage withholding tax is one of three kinds of "employment taxes," reference is also made to 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes* (U.S. Income Series), which discusses not only the international features of the U.S. social security tax (the FICA and SECA taxes), but also international aspects of the U.S. federal unemployment tax (FUTA).

### *B. Definition of "Wages"*

#### *1. Statutory Exceptions*

As indicated in II.A., above, the term "wages" is broadly defined in §3401(a) to include "all remuneration … for services performed by an employee for his employer" as well as "the cash value of all remuneration (including benefits) paid in any medium other than cash." However, §3401(a) then enumerates a number of specific exceptions that have the effect of exempting particular kinds of employment from the tax, as well as specific types of payments made to or for the benefit of an employee whose other salary remains subject to the tax.

The principal exemptions based on the nature of the employee's services are:

(i) active service of members of the Armed Forces receiving combat pay (§3401(a)(1)) if the employee is entitled to the benefits of §112;

(ii) agricultural labor (§3401(a)(2)) unless the remuneration paid for the labor is wages (as defined in §3121(a));

(iii) certain domestic service (§3401(a)(3));

(iv) certain services that are not part of the employer's trade or business (§3401(a)(4));

(v) work as the employee of a foreign government or international organization (§3401(a)(5)), discussed further in V.B.3., below;

(vi) services performed outside the United States, and in certain circumstances within the United States, by nonresident alien individuals (§3401(a)(6)), discussed further in V.A., below;

(vii) services performed outside the United States in a number of situations by U.S. citizens (§3401(a)(8)), discussed further in VI.A., below;

[10] *See* the Worksheets, below.

[11] For an exhaustive discussion of when an employer-employee relationship exists for federal employment tax purposes, *see* 391 T.M., *Employment Status — Employee v. Independent Contractor.*



ISBN 978-1-61746-986-2

(viii) services performed by a duly ordained, commissioned, or licensed minister (§3401(a)(9));

(ix) work done by Peace Corps volunteers (§3401(a)(13)); and

(x) certain fishing-related activities (§3401(a)(17)).

The principal exemptions which are based not on the nature of the employee's services, but on the nature of the particular kind of payment made to the employee or for his or her benefit, are as follows:

(i) non-cash remuneration paid for services not in the course of the employer's trade or business, such as free housing or food furnished to an employee of a homeowner whose cash salary is otherwise subject to wage withholding (§3401(a)(11));

(ii) payments made to employee benefit plans, employee annuities, and individual retirement plans pursuant to simplified employee pensions for the benefit of an employee or his or her beneficiary (§3401(a)(12));

(iii) premiums on group-term life insurance (even to the extent that such premiums may be taxable because they exceed the $50,000 limit of §79(a)(2) (§3401(a)(14));

(iv) reimbursed moving expenses, if it is reasonable to believe that the employee will be allowed a deduction under §217 (§3401(a)(15));[12]

(v) certain cash tips received by employees (§3401(a)(16));

(vi) payments under educational assistance programs and dependent care assistance programs under §127, §129, §134(b)(4) and §134(b)(5) (§3401(a)(18));

(vii) any employee achievement award, a scholarship, fellowship, or any fringe benefit provided to an employee where it is reasonable to believe that an exclusion will be available under §74(c), §108(f)(4), §117, or §132 (§3401(a)(19));[13] and

(viii) medical care reimbursements that are excluded from gross income under §105(h)(6), under an Archer medical savings account described in §106(b), or under a health savings account described in §106(d) (§3401(a)(20)–§3401(a)(22)).

As a general rule, the statutory exceptions to the definition of the term wages mirror fairly closely the exemptions from substantive personal income tax liability that are available to employees, although in a few instances a withholding tax exemption is allowed for administrative reasons even though the employee may be subject to personal income tax on the particular amounts paid to him or her by the employer.

*2. Administrative Exceptions*

There are a few instances in which an employee is exempt from personal income tax on a particular item of employer-provided remuneration, but where there is no statutory exception from wage withholding tax. Examples include employer contributions to employer-sponsored accident or health plans which are excluded from the employee's gross income under §106(a), and meals and lodging furnished for the convenience of the employer and excluded under §119. The IRS practice generally has been to allow an administrative exemption from wage withholding tax in these situations.[14]

*3. "Worldwide" Embrace of Section 3401(a)*

In general §3401(a) embraces all "wages" paid by every employer in the world to every employee in the world. Thus, §3401 is comparable to the provisions of the Code imposing substantive income tax liability on individuals, particularly §1, §871 and §911. In effect, §1 imposes federal income tax on every individual in the world. However, §871 then provides an exception from U.S. tax on most foreign-source income of nonresident aliens, while §911 exempts qualifying foreign-source earned income of U.S. citizens and resident aliens.

Section 3401 imperfectly mirrors the substantive tax rules contained in §1, §871 and §911, and other sections. As a result, wages paid to certain important categories of individuals are technically subject to wage withholding tax even though little or no substantive tax liability may result. By the same token, wage withholding tax is imposed where the employee will clearly have substantive U.S. tax liability, but where the IRS may nevertheless lack jurisdictional power to collect the tax from the employer. Examples of both situations are given in the more detailed discussion of the international wage withholding rules in VI., below.

### *C. Withholding Tax Rates and Procedures*

*1. In General*

To comply with its obligation to withhold taxes on wages, an employer must establish a formal payroll system consistent with the requirements of §3402 and its applicable regulations. For an analysis and explanation of the wage withholding tables and withholding methods, *see* 392 T.M., *Withholding, Social*

[12] The Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, §11049(a) suspended the deductibility of moving expenses under §217 for taxable years 2018 through 2025 by adding §217(k), which provides that except for members of the Armed Forces, §217 shall not apply to any taxable year beginning after 2018 and before 2026. However, the TCJA did not make any conforming amendment to §3401(a)(15). Nor did the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, §13213(d)(2) (1993 OBRA) make a conforming amendment to §3401(a) when it added §132(g) to the Code, which provides an exclusion from the gross income of an employee for the reimbursement of "qualified moving expense reimbursement" by an employer, which is also suspended for taxable years 2018 through 2025 by the TCJA (Pub. L. No. 115-97, §11048(a)), by the addition of §132(g)(2), exclusive of members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. *See* 594 T.M., *Tax Implications of Home Ownership* (U.S. Income Series), for a more detailed discussion of moving expenses.

[13] The TCJA, Pub. L. No. 115-97, §11048(a), added §132(g)(2), which suspends the exclusion from gross income of qualified moving expense reimbursements for taxable years 2018 through 2025 for all U.S. taxpayers except members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. However, no amendment was made to §3401(a), therefore, any such reimbursement should still be considered wages under §3401(a)(19).

[14] *See* Reg. §31.3401(a)-1(b)(9) (wage withholding exemption for remuneration that is expected to be excluded under §119); Rev. Rul. 61-146 (employer payment of group health insurance premiums for benefit of employees held not "wages" for §3401 purposes).



ISBN 978-1-61746-986-2

*Security and Unemployment Taxes on Compensation* (U.S. Income Series).

The general scheme of the wage withholding rules is that the employer first computes the amount of annual wages (as defined in §3401(a)) that it expects to pay to each employee. The employer then decides which of several computation methods to use in calculating the amount to be withheld from the employees' wages in each pay period. With respect to each computation method, the relevant wage withholding tables prescribe how much tax is to be withheld in each pay period, based on the employee's salary level and marital status. These tables assume that the employee has no dependents (other than a spouse), and that the employee will claim no deductions or credits on his or her federal income tax return. If the employee has other dependents or expects to claim deductions or credits, however, the employee may provide a statement to the employer on Form W-4, *Employee's Withholding Certificate*, in order to authorize the employer to reduce the employee's withholding tax so that it will approximate the amount of the employee's expected federal income tax for the year.[15]

Special withholding rules (described in II.C.8., below) may apply to employees who work for the employer for only part of the year, or who are exempt from U.S. withholding for part of the year. An employer who complies with its obligation to establish a payroll system to effect wage withholding will need to choose one of two alternative withholding methods to use (*see* II.C.2., immediately below) and timely deposit withheld taxes and other federal payroll taxes. *See* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series) for more detail on withholding from wages and collection at the source.

### 2. Percentage Method and Wage Bracket Method

The two principal methods prescribed by §3402 are the "percentage" method[16] and the "wage bracket" method.[17] While the two methods will usually result in approximately equal amounts of withholding with respect to a particular employee, the principal feature of the wage bracket method is that it is based on IRS tables which minimize calculations for the employer. In contrast, the percentage method requires the employer to make calculations that go through several steps:

(1) the calculation of how much of the employees' withholding exemptions[18] are allocable to wages paid during the pay period (these amounts then have the effect of reducing the amount of taxable wages for the pay period); and

(2) the calculation of wage withholding tax on net taxable wages for the pay period using incremental brackets which require one step of multiplication and one step of addition.

The wage bracket method is generally viewed as the better alternative and is more widely used by employers and by professional payroll services than is the percentage method.

The wage bracket tables may be used only if the employer's pay period is daily, weekly, biweekly, semimonthly, or monthly. The percentage method may be used as an alternative in these cases. If pay periods are longer than monthly (e.g., quarterly, semiannually, or annually), then the percentage method must be used.

The Code also contemplates that other methods may be devised by employers, so long as they result in withholding which is comparable to the percentage method or the wage bracket method.[19] IRS Publication 15-T, *Federal Income Tax Withholding Methods*, annually provides alternative formula tables for percentage method withholding and wage bracket method withholding for automated payroll systems. It also provides combined income tax and social security tax withholding tables, among other methods available for figuring income tax withholding.

### 3. Shorthand Features of the IRS Methods

Because of several "shorthand" features in the wage withholding system, it is rare that the amount of an employee's wage withholding tax for the year equals his or her actual personal income tax liability for the year.

The first shorthand feature is that historically the rates of withholding tax, and the brackets used, have not mirrored the dollar amounts and the percentages of the §1 income tax brackets. In recent years, however, the disparity has narrowed substantially. In addition, there are several shorthand features in the way that IRS Form W-4 (discussed below) calculates an employee's permissible withholding allowances.

Second, the more widely used wage bracket method only applies two sets of tables based on the employee's filing status — married and single — whereas the less commonly used percentage method contains the same four methods of §1 — married filing jointly, single, married filing separately, and head of household. The absence of married filing separately and head-of-household wage bracket tables has a particular impact on nonresident alien employees who are married. This is because a married nonresident alien employee must file a married filing separately tax return. All nonresident aliens (whether married or not) are subject under the Code to wage withholding as if they were single,[20] however, resulting in underwithholding if

[15] The withholding rules under §3402 were substantially modified to provide that withholding is based, in part, on an employee's withholding allowances, and not on the number of exemptions claimed by the employee. *See* Pub. L. No. 115-97, §11401(a), §11401(c), which generally applies to taxable years beginning after 2017. *See also Personal Exemption Tables* in Federal Tax Tables, Charts & Lists for personal exemption amounts in recent years under §151.

[16] §3402(b); Reg. §31.3402(b)-1 (clarifying that employers using percentage method of withholding must compute withheld tax amount based on entry for employee's anticipated filing status or marital status and other entries on employee's Form W-4 using applicable percentage method tables and computational procedures in applicable forms, instructions, publications, and other IRS issued guidance prescribed for use with respect to period in which wages are paid). Percentage method tables and computational procedures are provided in Publication 15-T, *Federal Income Tax Withholding Methods*. T.D. 9924, 85 Fed. Reg. 63,019.

[17] §3402(c); Reg. §31.3402(c)-1 (clarifying that using wage bracket withholding method and computational procedures based on entry for employee's anticipated filing status or marital status and other entries on the employee's Form W-4 should use applicable wage bracket method tables and computational procedures in forms, instructions, publications, and other IRS prescribed guidance issued for use with respect to period in which wages are paid). Wage bracket method tables and computational procedures are provided in Publication 15-T, *Federal Income Tax Withholding Methods*.

[18] For personal exemption amounts in recent years under §151, *see Personal Exemption Tables* in Federal Tax Tables, Charts & Lists.

[19] §3402(h); Reg. §31.3402(h)(4)-1.

[20] §3402(l)(3)(A); Reg. 31.3402(l)-1(d)(1)(ii).



ISBN 978-1-61746-986-2

the nonresident alien is married because the single rates result in lower tax than the married filing separately rates.[21]

*4. Avoidance of Overwithholding; Form W-4*

When starting employment, an employee is expected (although not required) to provide a Form W-4 to their employer, showing the amount of the employee's withholding allowances, including the standard deduction, and the total amount of other deductions and credits that the employee expects will reduce the employee's substantive tax liability for the year.[22] The calculations on Form W-4 will have the effect of reducing the employee's withholding tax so that any overwithholding that might otherwise occur will be reduced or eliminated.

The employee also indicates on Form W-4 whether the employee is married.[23] If the employee is married (and is not a nonresident alien), then the employee's wage withholding tax will be computed under the married withholding tables instead of the single tables. If the employee plans to file a married separate return, or if for some other reason the employee is concerned that underwithholding may occur (for example, because the employee may have outside investment income), the employee can request on Form W-4 that the employer withhold based on the tables for single employees. If the employee does not provide the employer with a Form W-4, then the employee is presumed to be single with no expected deductions or credits and the employer will withhold.[24] Thus, the employer will take into account only one personal exemption for withholding purposes.

If an employer has reason to believe that an employee's Form W-4 may be false, particularly based on oral or written statements of the employee made to any authorized payroll personnel, the employer is required to treat it as invalid and to request another withholding allowance certificate from the employee. If the employee fails to do, the employer must withhold on the assumption that the employee is single and claims no exemptions.[25] If a prior Form W-4 has been filed which the employer has no reason to believe is false, however, the employer may continue to withhold on the basis of it. If the IRS does review a particular employee's Form W-4 (as submitted to it by the employer), and if it believes the employee's Form W-4 to be false, it will notify the employer of the number of withholding exemptions (withholding allowances in taxable years beginning after 2017) used in computing wage withholding tax.[26]

As discussed further in V.C.1., below, in the case of most nonresident aliens working in the United States who are subject to wage withholding, only one withholding exemption may be claimed on Form W-4.

*5. Employee Who Expects No Tax Liability*

Section 3402(n) provides that if an employee expects to incur no income tax liability for the current year and incurred no liability for federal income tax in the preceding taxable year, the employee may claim exemption from wage withholding tax on Form W-4. This exception is widely used by employees who work part-time in low-paid jobs, such as students with summer jobs. It is also widely used by U.S. citizens and resident aliens working abroad, who may have no federal income tax liability by reason of the foreign tax credit and/or the §911 foreign earned income exclusion.

*6. Included/Excluded Wages*

Section 3402(e) provides that if an employee works in both covered and noncovered employment during a pay period of not more than 31 consecutive days, all of the employee's remuneration is subject to withholding. This rule applies only if one-half or more of the employee's time is in covered employment. Conversely, all of the employee's remuneration for the period is exempt from withholding if less than one-half of the employee's time is in covered employment. It would appear that this rule could apply so as to exempt individuals working partly outside the United States from wage withholding. This might be true if some portion of their remuneration during the pay period is wages (e.g., because it is for services performed within the United States), but where the larger portion of remuneration for the pay period is not wages. This could occur, for example, in the case of a nonresident alien employee visiting the United States on business, where less than half of his or her remuneration for the pay period is for work done in the United States. Similarly, a U.S. citizen may work during part of a pay period within the United States, but more than half of his or her remuneration for the pay period may be exempt from wage withholding because it is for services performed outside the United States which qualify for the exclusions under §911, §931, or §933, or because it is subject to foreign wage withholding.

The literal language of §3402(e) could be read as exempting all remuneration from wage withholding in the above situations. However, the Court of Claims has held under the identical language for purposes of the Federal Insurance Contributions Act (FICA), that where part of an alien individual's remuneration during a pay period is for work done within and without the United States, the included/excluded rule applies solely with reference to the remuneration for work done within the United States.[27] The IRS has also confirmed this rule for FICA purposes in Rev. Rul. 79-318, with respect to Canadian residents working as truck drivers on routes between Canada and the United States. In a Coordinated Issue Paper published in 1995,[28] however, the IRS conceded that both the Court of Claims decision and Rev. Rul. 79-318 could be wrong. The IRS stated, however, that if they are wrong, then in the case of

[21] Of course, whether there is net overwithholding or underwithholding will depend on other aspects of the nonresident alien's income tax return.

[22] §3402(f)(1), as amended by the TCJA, Pub. L. No. 115-97, §11041(c). *See also* Reg. §31.3402(f)(2)-1, §31.3402(m)-1 (updated to reflect changes made by TCJA). T.D. 9924, 85 Fed. Reg. 63,019 (Oct. 6, 2020).

[23] §3402(l); Reg. §31.3402(f)(2)-1.

[24] §3402(l); Reg. §31.3402(f)(2)-1(a).

[25] Reg. §31.3402(f)(2)-1(f)(3).

[26] Reg. §31.3402(f)(2)-1(g)(2). For a more detailed discussion, *see* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*, (U.S. Income Series).

[27] *Inter-City Truck Lines, Ltd. v. United States*, 408 F.2d 686 (Ct. Cl.1969).

[28] IRS Industry Specialization Program Coordinated Issue Papers: Shipping and Air Transportation Industry Coordinated Issue — Federal Income Tax Withholding on Compensation Paid to Non-Resident Alien Crew by a Foreign Transportation Entity, July 24, 1995, decoordinated by IRS Directive LB&I-04-0114-002 (Jan. 21, 2014) (decoordinating, effective January 21, 2014).



ISBN 978-1-61746-986-2

a nonresident alien employee, the employee's wages allocable to U.S. workdays would instead be subject to 30% withholding tax at source under §1441.

Even though compensation for personal services paid to a nonresident alien for work done in the United States generally is subject to §1441 withholding unless it is also subject to wage withholding under §3402, most U.S. tax treaties provide relief to nonresident alien individuals visiting and working in the United States on a short-term basis. Even in the case of a nonresident alien individual who is not eligible for treaty benefits, as a practical matter their employer is unlikely to withhold U.S. tax from the employee's salary whether the salary is exempt from wage withholding under §3402(e) and thus subject to withholding under §1441, or subject to wage withholding because the §3402(e) exception is not met.[29]

*7. Withholding on Supplemental Wages*

Instead of the graduated annualized rates that apply to regular wages under the percentage method and the wage bracket method, special withholding tax rules apply to "supplemental wage payments."[30] Supplemental wages are defined to include tips, bonuses, commissions, and overtime pay, which may relate to pay periods other than (or in addition to) the current pay period.[31] There are generally two procedures available to an employer for withholding on a payment of supplemental wages — the "aggregate" withholding procedure and the "optional flat rate" withholding procedure.[32] Under the aggregate procedure the employer aggregates the supplemental and regular wages for the current or most recent pay period and treats the total as a single wage payment for the regular pay period.[33] The optional flat rate procedure is generally available only if the employer has withheld income tax from regular wages paid the employee and if the supplemental wages are either not paid together with the regular wages or are separately stated on the payroll records of the employer.[34] If these conditions are satisfied, the employer may (but is not required to) use a flat rate instead of the aggregate procedure. The flat rate is determined under §1(i)(2). Any withholding allowances that have been claimed by the employee on Form W-4 are taken into account under the aggregate method, but not under the optional flat rate method.

If the total of the current and all previous supplemental wage payments made during the calendar year by one employer (including all persons under common control) to one employee exceeds $1 million, however, then "mandatory flat rate withholding" applies instead of the two alternative methods described immediately above. The excess amount is then subject to mandatory withholding at the maximum personal income tax rate for the year (thus, e.g., at the rate of 37% for 2025).[35] Mandatory flat rate withholding applies regardless of the amount of withholding that has occurred or the method used by the employer and regardless of the withholding allowances, exempt status, or additional withholding by the employee on Form W-4.[36] Despite these rules, it appears that in applying the $1 million threshold only payments from the employer to the employee that are classified as wages under §3401(a) may be considered. For example, it is possible for an employee working outside the United States to receive extremely large salary payments from a U.S. employer that are exempt from wage withholding, because they are excluded from gross income under the §933 exclusion, or because they are subject to foreign wage withholding (possibly at a very low foreign tax rate). In the latter case (but not the former) the payments may be taxable to the employee under §1, but they are nevertheless excluded from wages under §3401(a)(8)(A)(ii), discussed in VI.A.4., below.

Whether or not the mandatory flat withholding rules apply to a particular employee, if the employee's substantive tax liability on an item of supplemental wages is more than the amount withheld, he or she would usually need to make additional estimated tax payments or request that the employer effect "additional withholding" (as discussed below) to satisfy the balance of his or her estimated tax liability on the item.

*8. Additional Withholding*

Section 3402(i) permits an employee to request their employer to withhold additional amounts from the employee's remuneration. Two types of additional withholding are dealt with:

(a) "Additional withholding," provided for in §3402(i) and Reg. §31.3402(i)-1. If the employee requests an employer to withhold additional amounts from his or her wages (as defined in §3402(a)), the employer must comply with such request and deposit such additional amounts with the IRS, to the extent of any amounts remaining after the withholding of all applicable federal, state and local taxes. The request is made on Form W-4. In order for the employer to be subject to the additional withholding requirement, however, remuneration paid to the particular employee must apparently be subject to mandatory wage withholding under §3402. Thus, this requirement may apparently not be imposed on an employer who is not required to withhold any U.S. tax from the remuneration paid to the employee — e.g., if the employee is a U.S. citizen working abroad, all of whose remuneration is exempt from wage withholding because of the §911 exclusion in §3401(a)(8)(A)(i), or because it is subject to foreign wage withholding and exempt from U.S. wage withholding under §3401(a)(8)(A)(ii).

Additional withholding under §3402(i) might be requested by an employee in several situations, for example, if he or she has outside investment income and prefers not to make estimated tax payments to cover the related tax liability.

(b) "Voluntary withholding" under §3402(p), whereby an employee who is not subject to wage withholding on any of his or her remuneration may request his or her employer to withhold as if the employee were subject to the mandatory withholding rules. This request is also made on Form

[29] *See* the discussion in V.A., below.

[30] For additional details about the applicable rules, *see* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series).

[31] Reg. §31.3402(g)-1(a)(1).

[32] Reg. §31.3402(g)-1(a)(5).

[33] Reg. §31.3402(g)-1(a)(6).

[34] Reg. §31.3402(g)-1(a)(7).

[35] Reg. §31.3402(g)-1(a)(2).

[36] Reg. §31.3402(g)-1(a)(2).



ISBN 978-1-61746-986-2

W-4, in accordance with the procedures in the regulations.[37] Employees who typically might make such a request in a wholly domestic context might be agricultural workers, domestic servants in a private home, and ministers, all of whom are exempt from wage withholding under §3401(a). However, the regulations provide that certain kinds of remuneration may not be subject to a voluntary withholding agreement.[38] The exceptions which are of relevance for international employees include:[39]

- remuneration exempt from withholding because it is for services performed by a permanent resident of the U.S. Virgin Islands;
- remuneration exempt from withholding under the possessions and Puerto Rican rules of §3401(a)(8)(B) and §3402(a)(8)(C); and
- remuneration exempt from wage withholding by §3401(a)(5) for services rendered as the employee of a foreign government or international organization.

The rationale for many of these exceptions is not obvious; after all, the §31.3402(p)-1 regulations make it quite clear that an employer is not required to enter into a voluntary withholding agreement with an employee whose remuneration is wholly exempt from wage withholding. On the other hand, the exception for remuneration from a foreign government or international organization may reflect a concern on the part of the Treasury Department about sovereign immunity or that the United States' relations with certain foreign governments and international organizations might be strained if their U.S. employees were permitted to ask them for voluntary withholding agreements.

*9. Part-Year Employment*

The regulations contain rules on "part-year employment" which are intended to minimize the possibility of overwithholding in the case of an employee who works for an employer for only part of the year.[40] These rules illustrate an important feature of the entire wage withholding system which, although not expressly articulated in the Code, the regulations, or any of the IRS publications on the subject, can be of importance in this context.

The basic assumption underlying the various withholding methods that an employer may use (II.C.2., above) is that an employee who receives wages during a particular pay period has been an employee during all prior pay periods in the year and will continue to be an employee for all subsequent pay periods in the same year. Thus, the percentage method and the wage bracket method both compute an employee's withholding tax for the pay period on the basis of an amount that is expected to be the employee's federal income tax for the year on his or her wages for the period, multiplied by the number of pay periods during the year. Thus, if an employee who is paid weekly at $500 per week is hired for temporary employment that will last only eight weeks, that employee's wage withholding is computed on the assumption that the employee's gross income from wages for the year will be $26,000 (i.e., 52 weeks times $500 per week), and not the $4,000 that is expected to be paid to the employee for the eight weeks of the temporary employment.

The administrative justification for such a rule is clear. An employer usually would not know for certain whether the employee had worked for other employers earlier in the year (except as described further below), or whether he or she would work for other employers after the end of his or her eight-week employment. If wage withholding were based only on assumed annual wages of $4,000 and if the employee worked at comparable salaries for other employers during the year, substantial underwithholding of tax would occur. In addition, circumstances might change and the eight-week temporary employment might well be extended into permanent employment. In that case, if wage withholding for the first eight weeks were based on annualized salary of $4,000, underwithholding for that part of the year would also occur.

On the other hand, the wage withholding system that has been adopted can also result in significant overwithholding, depending on the facts. If, in the above example, the employee works for no other employer during the year, calculating withholding tax on the basis of a $26,000 annual salary will clearly result in overwithholding.

To reduce the likelihood of overwithholding, the regulations permit an employer to prorate an employee's expected remuneration for the year over other periods during the year in which the employee did not work. However, this method can only be used where periods of unemployment during the year have already occurred, and not where periods of unemployment are expected to occur later during the year. Thus, the "part-year" method of withholding could not be used in the above example if the eight-week period of temporary employment is in January and February. It could, however, be used if the eight-week period began after the employer's first pay period and if the employee did not work for a prescribed period of time before obtaining the eight-week temporary employment. The reason why the part-year method may not be used for expected future periods of unemployment, of course, is that circumstances may change and the employee may in fact continue to work for the entire year. If the employee has not worked for some prior period during the year, however, the facts of the nonemployment for that period are clear and cannot be changed.

---

[37] Reg. §31.3402(p)-1. Voluntary withholding under §3402(p) is almost always used in order to impose withholding at source on certain kinds of U.S. government payments, such as social security benefits, where the payments are otherwise exempt from withholding but where the recipient wishes to satisfy part or all of his or her tax liability by means of withholding on such payments. A request for withholding on a government payment is made on Form W-4V. However, §3402(p)(3) also contemplates that an employer and employee may agree that withholding will be done on remuneration for services that are not wages for §3401(a)(1) purposes, provided that any withholding agreement between the employer and employee complies with IRS regulations on the subject.

[38] Reg. §31.3401(a)-3.

[39] Reg. §31.3401(a)-3(b)(2).

[40] Reg. §31.3402(h)(4)-1(b). *See* Thomas Bissell, *New Regs Can Avoid Overwithholding on Wages of Those Employed for Part of Year*, 60 J. Tax'n 230 (1984).



ISBN 978-1-61746-986-2

In order for the part-year method to apply, the employee must furnish a statement in writing to the employer under penalties of perjury with the following information:[41]

(a) The last day of employment (if any) by any employer during the same calendar year prior to beginning his or her current employment.

(b) A statement that the employee is a calendar-year taxpayer.

(c) A statement that the employee reasonably anticipates that he or she will be employed for an aggregate of no more than 245 calendar days in terms of "continuous employment" (as specially defined) during the current calendar year.

In a cross-border employment context these regulations benefit employees who become subject to U.S. wage withholding only during the latter part of the year — for example, nonresident aliens moving to the United States, and U.S. citizens returning to the United States from abroad. These situations are discussed further in XII.C., below.

The principal practical impediment to the utilization of the part-year employment method is the complexity of the computational method described in Reg. §31.3402(h)(4)-1(b).[42] Perhaps for this reason, the regulations state that the employer "may" use the part-year employment method if so requested by an employee, but is not necessarily required to do so.

While a discussion of the computational issues is beyond the scope of this Portfolio, there are various ways in which an employee who is eligible for the part-year method and who might realize a significant cash flow benefit might utilize the Form W-4 procedures so that the employer will withhold at least as much tax in each pay period as would be required by following the rules in the regulations on the part-year method. It is suggested that an employee or an employer who wishes to assist an employee in this regard compare the method in the regulations with the Form W-4 procedures so as to calculate the amount of withholding allowances that would be in conformity with the part-year method. Provided that the resulting calculation does not deviate materially from the calculations that would result under the exact method in the regulations, §3402(h)(4) and Reg. §31.3402(h)(4)-1(a) would appear to permit some other calculation method to be used.

*Comment:* If the employee does not satisfy the 245-day test or otherwise fails to qualify for the part-year withholding method, there is no regulatory basis for the employee to claim additional withholding exemptions on his or her Form W-4 so as to result mathematically in an amount of withholding tax for the year that will approximate his or her substantive tax liability. Such a course of action could expose both the employee and the employer to penalties under the law.

#### *10. IRS Publications for Employers and Employees*

Because of the complexities involved in the actual calculations of wage withholding tax, the IRS has published IRS Publication 15, *(Circular E), Employer's Tax Guide*, to be used as a guide to the rules and calculations, Publication 15-A, *Employer's Supplemental Tax Guide*, and Publication 15-T, *Federal Income Tax Withholding Methods.*

For further guidance for employees on the wage withholding tax rules generally, *see* IRS Publication 505, *Tax Withholding and Estimated Tax*, which contains detailed rules on how to complete Form W-4.

### *D. Overview of U.S. Income Tax Withholding and Reporting on Wages in an International Context*

#### *1. General "Territoriality" of Wage Withholding Tax*

Although resident aliens and U.S. citizens may be able to exempt or exclude from U.S. income tax remuneration for services performed outside the United States (for example, under the foreign earned income exclusion of §911 or one of the possessions exclusions, discussed in VI., below), no such exemption or exclusion applies for work done *within* the United States. Accordingly, for compensation for services performed within the United States to be exempt from wage withholding tax, it must be specifically excepted under §3401(a).

Similarly, while a nonresident alien employee is exempt from U.S. income tax liability and wage withholding tax on remuneration for services performed outside the United States, in the absence of an exemption in the Code or by treaty for services performed within the United States, remuneration for U.S. workdays is subject to wage withholding tax.

This "territorial" basis for wage withholding tax in many cases is similar to the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) rules, which generally impose FICA and FUTA tax with respect to all work done by an employee within the United States in covered employment, but which provide an exemption in many cases for work done outside the United States.[43]

When it is necessary to apply the "territorial" basis for wage withholding tax, it is usually necessary to determine to what extent a particular employee's compensation is "sourced" either within or without the United States, and if sourced without the United States, whether it is sourced within a "foreign country" (or within Puerto Rico or a U.S. possession). In applying the U.S.-source rules, it is usually necessary to determine whether an employee's services were performed within or without the "United States" in a geographical sense.

The regulations do not specifically define the term United States for purposes of §3401, but the term is generally defined for purposes of the entire Code in §7701(a)(9) to include "when used in a geographical sense … only the States and the District of Columbia." Thus, the term does not include Puerto Rico or the other U.S. possessions, in contrast with the FICA definition of the term United States.

It is not entirely clear from the Code itself whether the term United States for purposes of §3401(a) also includes contiguous continental shelf areas that are included in the term United States under §638 for federal income tax purposes. If an employee does mining-related work on the U.S. continental shelf, his or her compensation is U.S.-source income for pur-

[41] Reg. §31.3402(h)(4)-1(b)(5).

[42] As redesignated from Reg. §31.3402(h)(4)-1(d). T.D. 9924, 85 Fed. Reg. 63,019 (Oct. 6, 2020).

[43] *See* 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*



ISBN 978-1-61746-986-2

poses of his or her federal income tax liability,[44] but §638 defines the term United States as including the U.S. continental shelf only "for purposes of this chapter" — i.e., chapter 1, dealing with the individual's substantive income tax liability. The reference to Chapter 1 clearly does not include the wage withholding rules of chapter 24 of the Code. Nevertheless, the regulations under both §638 and §3401(a) provide in effect that if an employee's compensation is subject to substantive tax liability under §1 or §871(b), his or her employer is also subject to wage withholding tax under §3401(a).[45]

*2. U.S. Sourcing Rules for Compensation for Services*

The sourcing rules with respect to compensation for personal services are in §861(a)(3) and §862(a)(3).[46] As a general rule, the Treasury regulations under these sections seek to match particular items of compensation to the geographical location where the individual performed the services that gave rise to the compensation.

These sourcing rules were designed with the performance of physical services in mind. Accordingly, when the service provider and service recipient are physically located in the same location, the rules can be applied objectively and without much dispute as to characterization or location. However, when the services are wholly or partly automated or when the service provider and service recipient are located in different jurisdictions, the determinations as to where the services were performed and who performed them can raise difficult factual and conceptual issues.

Generally, compensation for services performed entirely outside the United States is considered foreign-source, and compensation for services performed entirely within the United States is considered U.S.-source. When the services are performed by an individual partly within and partly outside the United States, the compensation is sourced under the facts and circumstances of the particular case, with the regulations acknowledging that, in many cases, apportionment on the "time basis" described in §1.861-4(b)(2)(ii)(E) will be acceptable.[47]

*3. General Rules for Employee Compensation*

Subject to two exceptions, compensation to an employee for services performed partly within and partly outside the United States is sourced on the time basis of §1.861-4(b)(2)(ii)(E). The first exception is for fringe benefits described in §1.861-4(b)(2)(ii)(D)(1)–(6). Employee compensation attributable to those fringe benefits are sourced on a geographic basis generally where the employee's "principal place of work" is located.[48] The second exception permits an individual to adopt an alternative basis (subject to IRS approval) or the IRS to adopt an alternative basis if it is more reasonable than that used by the employee.[49]

The Code also contains special sourcing rules that reverse the sourcing that would otherwise occur. For example, §861(a)(3) contains two special exceptions (discussed in V.B.1., below) which can treat compensation for services done within the United States by a nonresident alien individual as foreign-source rather than as U.S.-source. Similarly, §863(c) and §863(d) contain special sourcing rules that apply to employees engaged in international transportation (shipping and aircraft), as well as employees engaged in non-transportation activities on the high seas (defined as "ocean activity"). Depending on the employee's U.S. tax status and the nature of the transportation activity, §863(c) can classify compensation for services performed over international waters as U.S.-source.[50] Also depending on the employee's U.S. tax status, §863(d) generally treats compensation for non-transportation services performed by an employee on the high seas — defined to be ocean activity — as U.S.-source income if the employee is a "United States person" (generally, a U.S. citizen or resident alien), but as foreign-source income if the employee is a nonresident alien.[51]

*4. Fringe Benefits*

*a. In General*

Employees sent to work in another jurisdiction are often provided with special "allowances" in addition to the standard package of fringe benefits that their employers also provide to employees not on international assignment. Such allowances may include reimbursement for the employee's moving expenses in moving to a new location; reimbursement for part or all of the employee's living expenses (housing, meals, laundry, and telephone expense); company-provided transportation (such as a company car); reimbursements for the employee's children to attend private schools in the language of their home country; home leave reimbursements for the employee and his or her family to return on vacation to their home country periodically (usually at least once annually); low-interest or interest-free loans to be used to purchase a home; and tax equalization payments to reimburse the employee for the excess cost of the host country's taxes when compared with the hypotheti-

[44] Section 638 provides that for purposes of chapter 1 of the Code, including the rules applied under §861(a)(3) for purposes of determining whether a nonresident alien is performing services within the United States, the term United States includes "the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources." Thus, an individual who is classified as a nonresident alien for federal income tax purposes and who works on an oil-drilling rig on the U.S. continental shelf outside the territorial waters of the United States is subject to federal income tax on his or her wages (assuming that he or she does not otherwise satisfy the three-pronged test of §861(a)(3)). *See* CCA 201027046 (unless exempted by treaty, compensation of nonresident alien employees of foreign corporation engaged in §638 activities is subject to U.S. taxation; because activities occur within United States and employees generally will not qualify for §864(b) business visitor exception, employees are deemed to have income effectively connected to U.S. trade or business). *See also* IRS LMSB Industry Directive #1 on U.S. Outer Continental Shelf Activity, LMSB-4-0909-037, issued on October 28, 2009.

[45] *See* Reg. §1.638-1(f) *Ex.* 6, and Reg. §31.3401(a)-1(c).

[46] For an exhaustive discussion of the Code's source rules applicable to income from personal services (whether realized by employees, self-employed individuals, corporations, or other persons), *see* 6620 T.M., *Source of Income Rules.*

[47] Reg. §1.861-4(b)(2)(i).

[48] *See* II.D.4., below.

[49] Reg. §1.861-4(b)(2)(ii)(C).

[50] *See* further discussion in V.B.5., below, with respect to nonresident aliens.

[51] In the absence of these special rules, compensation earned by a U.S. citizen or resident alien for work done on the high seas would usually be foreign-source income, which could be favorable for the employee if he or she had excess foreign tax credits.



ISBN 978-1-61746-986-2

cal tax that the employee would have paid to the home country if the employee had not been transferred to the host country.[52] Wage withholding may be required with respect to a particular payment, depending on the particular facts and the relevant tax rules.

Employees on international assignments will usually be reimbursed as well for normal business expenses incurred by them as part of their regular business activities. In general, no wage withholding is required by virtue of the general rule in Reg. §31.3401(a)-1(b)(2), to the effect that the reimbursement of an employee's deductible business expenses is exempt from wage withholding. Under the "accountable plan" rules enacted by §62(c) by the Family Support Act of 1988,[53] however, wage withholding could be imposed if the employer reimbursements do not follow the requirements of the accountable plan regulations in Reg. §1.62-2 and Reg. §31.3401(a)-4.[54]

*Comment:* The issue of reimbursement of expenses typically arises in the context of an existing employee directed by an employer to perform services in a new jurisdiction. Employees hired with the expectation that they will reside and perform services in a location other than the employer's or that relocate for personal reasons but continue to perform remotely their services as employee may not be reimbursed for such expenses and their compensation would be subject to the general rules above notwithstanding the incurrence of such unreimbursed expenses.

In the case of any reimbursement or other type of employer-provided allowance, whether provided "in kind" or in the form of direct payment to a third-party provider of goods or services, any items that are subject to wage withholding tax must be withheld in some manner by the employer. If the employee is reimbursed directly in cash, the wage withholding tax must either be withheld from the reimbursement, or withheld from the employee's other taxable wages, or the payment must be "grossed up" by the employer so that sufficient wage withholding tax is paid to the IRS on the grossed-up amount. Wage withholding tax would be either at graduated rates, or in the case of non-recurring payments the employer would usually withhold at the optional flat rate of 25% for supplemental wages.

Although wage withholding is typically required on employer-provided allowances that are taxable to the employee, in the case of certain allowances the employer may not be required to withhold but only required to report the income as "other compensation" on the employee's Form W-2. Examples include employer-provided automobiles and imputed income arising out of employer-provided low-interest loans.

*b. Temporary Living Expenses*

If an employee's "tax home"[55] remained in the employee's home country during part or all of the temporary assignment in the host country, part or all of the employee's temporary living expenses in the host country may have been tax-deductible under §162(a)(2) in taxable years beginning before January 1, 2018. Section 162(a) permits an employee to claim a deduction for "traveling expenses (including amounts expended for meals and lodging …) while away from home in the pursuit of a trade or business." However, the Tax Cuts and Jobs Act (TCJA) added §67(g) to the Code, which suspends the allowance of any miscellaneous itemized deductions, notwithstanding §67(a), for any taxable year beginning after December 31, 2017 and before January 1, 2026.[56] If eligible expenses are reimbursed directly pursuant to an accountable plan, the practical effect is that they are excluded from the employee's gross income. If they are not reimbursed directly, the employee could deduct the expenses in tax years beginning before January 1, 2018, subject to the 2%-of-adjusted-gross-income rule of §67(a).

With respect to the location of an individual's tax home, §162(a) provides that an employee "shall not be treated as temporarily away from home during any period of employment if such period exceeds 1 year." The IRS interpreted this rule in the context of several alternative fact patterns in Rev. Rul. 93-86. In two fact patterns the IRS ruled that an individual's tax home would shift from one location to another where:

> (1) the individual moves to the new location, expects to remain there more than 12 months, and does in fact remain more than 12 months; and
>
> (2) the individual moves to the second location, expects to remain there more than 12 months, but moves back to the first location before 12 months have elapsed.

In the third fact pattern, however, the IRS ruled that if the individual moves to the second location and expects to stay less than 12 months, but if the individual's plans later change and the individual stays more than 12 months, he or she may claim away-from-home living expenses on the basis that the tax home remains at the first location up to the date that the individual's plans change.

*Comment:* Revenue Ruling 93-86 offers planning possibilities for nonresident aliens whose plans with respect to the period of their U.S. employment are flexible. Care should be exercised in the decisions regarding any change in employer (e.g., if the employee is transferred to the payroll of a local company) lest the employee's tax home change.

[52] The wage withholding tax effects of standard allowances that are usually provided to all employees, such as coverage in group insurance plans (medical, life, and disability insurance), and coverage in the company's retirement plans are not further discussed, except for the treatment of nonqualified retirement plan coverage, which is discussed in II.E.7., below.

[53] Pub. L. No. 100-485, §702(a) (1988).

[54] *See* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series), and 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses* (U.S. Income Series). The IRS has stated that the accountable plan rules apply equally to nonresident aliens working within the United States, as well as to U.S. citizens and resident aliens. *See* December 16, 1998, IRS Letter to Coopers & Lybrand, LLP, Regarding Whether Withholding Agent Is Required to Withhold Tax on Reimbursed Expenses Paid to Nonresident Alien Guest Lecturers, reproduced in Worksheet 5 of 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers.*

[55] The term "tax home," relating to travel expenses while away from home, generally means an individual's regular or principal (if more than one regular) place of business. If the individual has no regular or principal place of business because of the nature of the business, or because the individual is not engaged in carrying on any trade or business within the meaning of §162(a), then the individual's "tax home" is the individual's regular place of abode. *See* Reg. §301.7701(b)-2(c), defining the same meaning of tax home for purposes of §162(a).

[56] *See* Pub. L. No. 115-97, §11045.



ISBN 978-1-61746-986-2

The tax home rules apply uniformly to all individuals working in the United States, and to U.S. citizens and resident aliens working abroad. It is not relevant whether an individual is a resident alien or nonresident alien or, in the case of a U.S. citizen, whether the individual is a "bona fide resident of a foreign country" for §911 purposes. Thus, for example, a resident alien who satisfies the 12-month rule with respect to a temporary U.S. assignment would be entitled to claim tax home deductions in the same manner as a nonresident alien who also satisfied the 12-month test.

Publication 519, *U.S. Tax Guide for Aliens,* provides general guidance regarding the deductibility of travel expenses and moving expenses incurred by employees who have a temporary job site in the United States and a tax home outside the United States. Generally, for taxable years beginning before January 1, 2018, moving expenses of a nonresident alien temporarily in the United States and earning taxable income for performing personal services were deductible if both of two tests were met. The first test was a length of employment test and the second test was a distance test. For tax years beginning after December 31, 2017, moving expenses are not deductible except for members of the U.S. Armed Forces who move under military orders incident to a permanent change of station.[57] Although Publication 519 deals with aliens working in the United States, the same rules would apply in the case of a U.S. citizen or resident alien working temporarily abroad.

Expenses incurred for accompanying family members were not eligible for tax home deductions, including transportation costs in moving family members and their personal belongings to the host country. If the employee's tax home did shift to the host country however, part or all of the cost of moving family members to the host country may have been deductible under §217 in tax years beginning before January 1, 2018.

For taxable years beginning before January 1, 2018 and after December 31, 2025, the principal fact patterns, and the related wage withholding rules, were and will be (assuming there are no changes) as follows:

(i) **The employee is reimbursed in full for deductible tax home expenses (i.e., for his or her temporary living expenses in the host country).** In this case the reimbursement is exempt from wage withholding tax under the general business expense reimbursement rule in Reg. §31.3401(a)-1(b)(2), provided that the "accountable plan" rules of Reg. §31.3401(a)-4 are met. If they are not met, then part or all of the reimbursement may be subject to wage withholding tax according to the rules described further below.

(ii) **The employee is not reimbursed by the employer for any temporary living expenses in the host country.** In this case the employee would claim a deduction on the employee's federal income tax return subject to the 2%-of-AGI rule of §67. If the employee wished to reflect the anticipated deduction in the employee's wage withholding, the employee would increase the number of withholding allowances on Form W-4. If the employee were a nonresident alien, however, this would not be permitted (*see* the discussion in V.C.1., below), and instead the employee would have to wait until filing his or her tax return for the year in order to obtain a refund of the over withheld tax.

(iii) **The employer reimburses the employee, but excess reimbursements occur.** In this case, the "accountable plan" rules in Reg. §31.3401(a)-4 could require wage withholding on all reimbursements.

(iv) **The employer partially reimburses the employee.** In this case, the reimbursed portion would be exempt from wage withholding if the accountable plan tests were met, and the unreimbursed excess could be reflected in the employee's wage withholding on Form W-4 (but only if the employee is a U.S. citizen or resident alien).

If an employer chooses to reimburse the living expenses of an employee who is eligible to claim tax home deductions, the employer may do so under a "per diem" arrangement as prescribed in various IRS rules. In the case of employees working within the United States, Publication 1542 describes the detailed rules that are applied by the IRS.[58] Publication 1542 contains charts showing the per diem allowance for lodging and for meals in a number of specific cities and localities within the United States. Alternatively, the employer may use the applicable standard federal per diem rates. The per diem rates that may be used for employees working temporarily outside the United States are on the General Services Administration website, at *www.gsa.gov*. An employer may have a per diem arrangement that covers lodging but not meals, or meals but not lodging, or both.

A per diem arrangement has the potential advantage of permitting part of an employee's salary in effect to be paid by the employer as part of the employee's per diem amount, to the extent that the per diem is expected to exceed the employee's actual living expenses. Such excess would be free of wage withholding tax and would not be reported on the employee's Form W-2. One disadvantage of a per diem arrangement, however, is that it probably should not be used for days that the employee is on business trips away from the temporary work location. If the employee does make business trips away from the temporary work-site, in most cases the employer would reimburse the employee for the actual expenses incurred by him or her on those trips. It would be inconsistent for a per diem allowance to be paid to the employee to cover the cost of lodging and other living expenses on the same days at the place where the employee maintains his or her temporary home. A reimbursement program based on actual expenses would minimize this problem, because the argument could be made that the reimbursement for the actual expenses of lodging and related expenses at the temporary home should probably be allowed even on days that the employee is temporarily away from that place on business.

*c. Housing*

In the absence of a tax home deduction, an employee's housing is generally not deductible, and employer-provided housing is fully taxable and subject to wage withholding tax.

[57] *See* Pub. L. No. 115-97, §11049 (2017).

[58] *See also* Rev. Proc. 2019-48, *superseding* Rev. Proc. 2011-47.



ISBN 978-1-61746-986-2

However, if the housing qualifies for exclusion from the employee's gross income under §119 for meals and lodging furnished at the convenience of the employer, it would be exempt from wage withholding tax under Reg. §31.3401(a)-1(b)(9). Support for claiming the exclusion in the case of an international employee might be based on the case of Faneuil Adams, which involved a U.S. citizen living in Japan.[59]

From a practical standpoint, a U.S. citizen or resident alien who qualifies for the §911 exclusion may have no need to claim the §119 exclusion due to the deduction for housing available under the §911 exclusion. In the case of an individual working in the United States who does not qualify for the §162 housing deduction, however, the §119 housing exclusion would usually offer a significant tax saving if it were available.

The TCJA, Pub. L. No. 115-97, added §67(g) to the Code, which provides that no miscellaneous itemized deductions will be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026, notwithstanding §67(a).[60] Section 67(b) defines miscellaneous itemized deductions for this purpose as the itemized deductions with specified exceptions; §162 is not excepted.

*d. Home Leave Expenses*

To the extent that the employer reimburses the employee and other family members for air travel to vacation in their home country, or pays such costs directly, such costs should also be classified in most cases as wages subject to withholding.[61] If the employee's trip were considered a business trip, on the other hand, no withholding would be required on that portion of the reimbursement.

*e. Tuition Expenses for Dependents' Private Schooling*

There is no statutory or regulatory basis for excluding reimbursements for the cost of private schooling from the employee's gross income even if the employee is entitled to a deduction for his or her own living expenses under the "tax home" rules. Accordingly, such reimbursements are subject to wage withholding.

*f. Personal Use of Automobile*

An employer is required to report the value of a company-provided automobile on an employee's Form W-2, to the extent of the personal non-business use of the automobile. Under §3402(s), the employer may elect not to withhold on the taxable value of the automobile.[62] If the employee believes that a portion of the value of the automobile reported on Form W-2 is allocable to deductible business use, in taxable years beginning before January 1, 2018, the employee could have deducted such portion subject to the 2%-of-AGI rule of §67. That deduction should become available again in taxable years beginning after December 31, 2025, unless this restriction is extended.[63]

As a general rule, personal use of a company car would include use in commuting to work. If the employee is eligible for the tax home deduction, however, use of the car for commuting between the employee's U.S. lodging and his or her U.S. place of business is non-taxable business use.

*g. Devices Used for Communications*

Whether an employee is eligible for the tax home deduction, the personal use of a telephone or other device used for communication is not tax-deductible under the IRS's tax home guidelines. Business use of the employee's personal communication device would be tax-deductible, however, in years in which itemized deductions were deductible. The TCJA, Pub. L. No. 115-97, added §67(g) to the Code, which provides that no miscellaneous itemized deductions will be allowed for any taxable year beginning in 2018 through 2025.[64] Section 67(b) defines miscellaneous itemized deductions for this purpose as the itemized deductions with specified exceptions; §162 is not excepted.

*h. Moving Expenses*

Section 132(a) provides that qualified moving expense reimbursements are fringe benefits that are not included in gross income. For taxable years beginning before January 1, 2018, former §132(g) defined the term qualified moving expense reimbursement as an amount received by an individual from an employer as payment for (or reimbursement of) expenses that would be deductible as moving expenses under §217 if directly paid or incurred by the individual, exclusive of any payment for (or reimbursement of) an expense actually deducted by the individual in a prior taxable year. To the extent that an employer reimbursed an employee for moving expenses that the employee expected to be excludible under former §132(g), §3401(a)(15) provides an exemption from wage withholding tax.[65] In the case of an employee who moved from the United States to a foreign country, however — whether a U.S. citizen or an alien — §265 could have had the effect of denying the §132(a)(6) exclusion to the extent that the individual's earned income after the move might be tax-exempt, either because the employee would be a nonresident alien, or a U.S. citizen or resident eligible for the §911 exclusion. Thus the reimbursement in some cases might have been taxable under §82 but a §217 deduction would have been denied by reason of §265.[66]

The TCJA, Pub. L. No. 115-97, amended §132(g), leaving the definition of qualified moving expenses as §132(g)(1) and adding §132(g)(2), which provides that the exclusion from gross income for qualified moving expense reimbursements in §132(a)(6) will not apply to any taxable year beginning after December 31, 2017, and before January 1, 2026, except in the case of an active duty member of the U.S. Armed Forces who moves under a military order and incident to a permanent change of station.[67]

[59] *Adams v. United States*, 585 F.2d 1060 (Ct. Cl. 1978).

[60] Pub. L. No. 115-97, §11045.

[61] The value of free vacation trips provided to an employee is classified as wages subject to withholding. *Campbell Sash Works, Inc. v. United States*, 63-1 USTC ¶ 9421 (N.D. Ohio 1963); *ABC Freight Forwarding Corp. v. United States*, 68-1 USTC ¶ 9282 (S.D.N.Y. 1968).

[62] *See* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series).

[63] *See* §67(g).

[64] Pub. L. No. 115-97, §11045.

[65] Section 3401(a)(15) has not been amended to reflect the enactment of the §132(g) exclusion in 1993, but the intent is presumably the same.

[66] *See generally* Rev. Rul. 75-84, and Rev. Rul. 75-85, *amplified by* Rev. Rul. 76-162.

[67] Pub. L. No. 115-97, §11048.



ISBN 978-1-61746-986-2

*i. Tax Equalization Payments*

Payments to an employee to reimburse the employee for increased tax obligations as a result of the move to another jurisdiction (tax equalization payments) are in all cases classified as wages subject to withholding.

Note that for purposes of the §409A rules (enacted in 2004), a properly structured tax equalization plan is excluded from the §409A rules.[68]

*j. Low-Interest or Interest-Free Loans*

Where an employer loans funds to an employee at a below-market interest rate, the "bargain element" will usually be treated as imputed income to the employee under §7872(c)(1)(B) as part of a "compensation-related loan." Although this income must be reported as "other compensation" on the employee's Form W-2, §7872(f)(9) exempts this income from wage withholding.

*k. Cost of Meals*

The cost of meals raises special questions because of the general rule in §274(n) that generally permits only 50% of the cost of meals to be deducted. In effect, if the employer reimburses the employee for meals that are deductible in principle by the employee under the tax home rules, the employee is not taxed on the reimbursement (whether the reimbursement is pursuant to a per diem plan, or on the basis of actual reimbursements) and the reimbursement is not subject to wage withholding tax. At the same time, the employer may only deduct 50% of its cost in calculating its own federal income tax. However, in taxable years beginning before January 1, 2018, if the employee was not reimbursed for the cost of tax-deductible meals, he or she could only deduct 50% of business meals, and thus in calculating the amount of the employee's withholding allowances for Form W-4 purposes, the employee should have taken into account the 50% deduction disallowance and also the 2%-of-AGI rule under §67 on the deductible portion in effect during those years. If the employee was a nonresident alien, of course, the employee would not have been permitted to reflect the tax-deductible portion of business meals on Form W-4.

For taxable years beginning after December 31, 2017, and before January 1, 2026, no miscellaneous itemized deductions are allowed.[69]

*l. Reimbursement of U.S. Education Expenses of a Nonresident Alien Student*

Foreign employers sometimes finance part or all of the cost of foreign-based employees to attend graduate school in the United States to acquire professional training. If this is done in the form of an employer reimbursement of the foreign student's tuition and U.S. living expenses (or direct payment of those expenses by the foreign employer), the question arises whether part or all of these payments or reimbursements are taxable to the employee as disguised salary or as a taxable scholarship, and thus potentially subject to U.S. withholding tax under either §3401(a) or §1441 on the part of the foreign employer. Although it is unlikely that many foreign employers are even aware of these issues, the tax issues can be quite complex.[70]

*m. Miscellaneous Fringe Benefits*

There are numerous other employer-provided fringe benefits that may be provided generally by a U.S. employer to both employees on an international assignment, and to employees working permanently within the United States. These include reimbursements of commuting and parking costs, various kinds of welfare costs, employer-paid health insurance, employer-paid life insurance, and numerous other benefits. A full discussion of these and other employer-provided fringe benefits is in 394 T.M., *Employee Fringe Benefits* (U.S. Income Series).

*5. Sourcing of Taxable Allowances*

As discussed in V. and VI., below, under Reg. §1.861-4(b)(2), taxable fringe benefits paid to a U.S. citizen or resident alien working abroad or to a nonresident alien working in the United States are divided into two groups for determining their source as income:

> (1) six specified categories of fringe benefits — housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay, and taxable moving expense reimbursements — are sourced geographically, either at the employee's principal place of employment or in the country where the benefit is applicable; and
>
> (2) all other taxable fringe benefits are allocated between U.S. and foreign sources in the same manner as the employee's base salary.

This latter rule is generally favorable for U.S. citizens and resident aliens working abroad who make business trips back to the United States, because it treats most fringe benefits as foreign-source and thus increases the employee's allowable foreign tax credits. Conversely, the rule can be detrimental to nonresident aliens working temporarily within the United States who make foreign business trips (or resident aliens working in the United States who have accumulated excess foreign tax credits and who make foreign business trips) because it increases the amount of the employee's U.S.-source income that is either subject to tax (in the case of nonresident aliens) or it decreases the amount of foreign-source income that may be sheltered by foreign tax credits (in the case of resident aliens).

Technically, these sourcing rules should be reflected in the employer's payroll system.

*6. Potential Section 6662 Penalty*

If neither the employer withholds on a particular type of allowance nor the employee reports the allowance on the employee's tax return for the year, a penalty of 20% could be imposed on the employee under §6662. This would occur if the employee is audited on the issue, loses on the issue, and it is determined that there was neither "disclosure" of the issue on the

[68] *See* Reg. §1.409A-1(b)(8)(iii).

[69] §67(g). *See* Pub. L. No. 115-97, §11045.

[70] While a discussion of these issues is beyond the scope of this Portfolio, the most important issues are discussed in 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers,* and in 518 T.M., *Exclusion of Scholarships and Other Receipts for Education* (U.S. Income Series).



ISBN 978-1-61746-986-2

return nor "substantial authority" for the position taken. Such a situation could arise, for example, if an employer and employee claimed the §119 exclusion with respect to employer-provided housing, or if an employer reimbursed an employee for his or her housing cost under an accountable plan.

### *E. Withholding on Bonuses and Deferred Compensation*

#### *1. In General*

This section deals primarily with the payment of bonuses and other kinds of deferred compensation in an employer-employee context. In most cases the payment is being made for services that were rendered by the payee during one or more periods prior to the current pay period. Except for the discussion in II.E.6.a. and II.E.7., below of deferred compensation paid out of trust funds or similar funding vehicles, this section discusses only payments that have not been previously funded by the employer and which are made out of the general unsecured funds of the employer.

The two most important factors regarding U.S. substantive tax liability and wage withholding are the source of the payment (i.e., whether the services for which the employee is being paid were rendered within the United States or abroad), and the status of the employee at the time of receipt as a nonresident alien, U.S. citizen, or resident alien.

The IRS has ruled that the payment of unfunded deferred compensation by an employer to an employee (or former employee) in a wholly domestic context is gross income to the employee and is subject to withholding as "wages" under §3401(a).[71] As discussed in II.E.3., II.E.4., and II.E.5., below, however, certain exceptions in the case of international employment may apply so as to eliminate both liability and wage withholding. In addition, to the extent that a bonus or deferred compensation payment is subject to wage withholding, in most cases the employer would be entitled to treat it as "supplemental compensation" taxable at the optional flat rate of 25%.

#### *2. Section 409A Rules*

As a result of the enactment of §409A, all deferred compensation plans must be tested under the provisions of that section to ensure that the deferred compensation is not taxed in a year prior to the payment due date, and is not subject to the 20% penalty of §409A(a)(1)(B)(i)(II). Although the principal focus of most employers and their employees is on unfunded deferred compensation plans maintained by a U.S.-based employer for its U.S.-based employees, §409A can apply to:

(i) U.S. citizens and resident aliens working abroad for either a U.S.-based or a foreign-based employer, and

(ii) to nonresident or resident aliens working in the United States who participate in a plan maintained by a current or former employer based in a foreign country.

A detailed examination of the effect of §409A in an international context is at 385 T.M., *Deferred Compensation Arrangements* (U.S. Income Series).

Because a plan that runs afoul of §409A (resulting in current taxation to the employee, together with the 20% penalty tax) does not result in a corresponding wage withholding obligation on the employer, the details of §409A are not discussed in this section.[72] However, an employer (whether U.S.-based or foreign-based) the employees of which are potentially subject to U.S. income tax should always analyze its deferred compensation plans to determine whether they are "§409A-compliant," and, if not, what steps should be taken to make them §409A-compliant. There are two reasons for this. First, the employer should be careful not to maintain a plan that could result in the imposition of current tax, plus the 20% penalty, on an employee who might not have the cash to pay the tax and the penalty. Second, the employer must determine how much of an employee's accrued deferred compensation (if any) is properly deferrable under §409A, and how much (if any) is currently taxable under §409A. The deferred portion is optionally reportable on the employee's Form W-2 in box 12 (using code Y), and the current taxable portion is reported in both box 1 as currently taxable wages and in box 12 (using code Z).[73]

If the deferred compensation plan is maintained by a foreign employer that is not engaged in a trade or business in the United States — for example, by a foreign subsidiary, parent, or sister company of the U.S. company that either sent the employee abroad (in the case of a U.S. citizen or resident alien) or that is employing the employee temporarily within the United States (in the case of a resident or nonresident alien), the question arises whether Form W-2 reporting is required to be done. To the extent that other forms of compensation that are currently taxable to the particular employee (such as current salary, or current payments of deferred compensation from prior years that did not run afoul of §409A) are not required to be reported on Form W-2, it would seem that deferred compensation that is taxable currently under §409A would also not have to be reported on Form W-2. However, if the employee also receives compensation from an employer that must be reported on Form W-2, and if that employer also includes on the Form W-2 current compensation that is paid by a related foreign company in the group (even if such reporting is technically not required under the law), then it would be advisable to also report deferred compensation that is accrued under a plan maintained by that foreign employer, whether or not the foreign plan is §409A-compliant.[74]

The discussion in the rest of this section assumes (unless otherwise indicated) that if an employee participates in a deferred compensation plan with either a U.S. or foreign employer, the plan is §409A-compliant.

[71] Rev. Rul. 77-25.

[72] Thus, if §409A applies, the employee is required to pay the tax, plus the 20% penalty, on his or her own behalf on a self-assessed basis. The employer, however, is required to report the amount that is taxable to the employee on the employee's Form W-2 for the year.

[73] *See* the IRS instructions to Form W-2.

[74] For example, if a U.S. parent company and its foreign subsidiary both pay current salary to a U.S. citizen working abroad and if the U.S. parent company includes both salaries on the employee's Form W-2, it should report all information concerning the employee's participation in a deferred compensation plan that is maintained by the foreign subsidiary.



ISBN 978-1-61746-986-2

*3. Nonresident Alien Recipient*

*a. Payment Is Foreign-Source Income*

If a bonus or unfunded deferred compensation is paid to a nonresident alien employee, and the payment is foreign-source income, the payment is exempt from both substantive liability and wage withholding tax. This is because the payment is for services rendered by the employee entirely outside the United States, and as such it cannot be subject to U.S. tax in the hands of a nonresident alien employee either at the gross 30% rate under §871(a) or at graduated rates as "effectively connected income."[75] The payment is thus free of U.S. tax to the nonresident alien employee whether the employee is living and working within or without the United States at the time of payment, whether or not the employer making the payment is a U.S. or a foreign company, and whether or not the employee may have been a resident alien at the time the services were rendered to the employer.

Typically a payment of this kind would be made to a nonresident alien employee after the employee moved to the United States, but for services rendered abroad before the move. Because of the absence of U.S. tax, such an arrangement can thus be an important tax planning scheme if it is also free of tax in the employee's home country or previous place of employment.

Because foreign-source compensation paid to a nonresident alien is exempt from U.S. wage withholding and from substantive tax liability to the employee, it may be possible for a resident alien or nonresident alien who works temporarily in the United States and who makes frequent business trips outside the United States to arrange for a "split contract." Under such a plan, the individual's salary for U.S. workdays is paid to the employee currently but salary for non-U.S. workdays is deferred until after the individual moves out of the United States and becomes a nonresident alien. It is possible, however, that in the event of an IRS audit, it might be necessary to prove that there had been a business purpose for the deferral of tax only on the salary allocable to non-U.S. business days. If this plan is effective and if it does not run afoul of §409A, however, the payment of the deferred foreign-source income after the employee has resumed nonresident alien status should be exempt from U.S. wage withholding tax and from substantive tax liability. In addition it should be tax-deductible by the U.S. employer for corporate income tax purposes. The employee would have to determine, however, to what extent the payment might be taxable to him or her under the tax laws of one or more foreign countries.

*b. Payment Is U.S.-Source Income*

Where a nonresident alien employee receives a bonus or unfunded deferred compensation payment for services rendered in the United States, the payments are U.S.-source income. The tax rules that apply to such payments are essentially the same as those that apply to a U.S. citizen or resident alien working in the United States in a wholly domestic context. Thus, the payment would usually be eligible for wage withholding tax as "supplemental" wages at the flat 25% rate, and the employee would include the payment in his or her gross income for the year. The employee would compute his or her tax at graduated rates applicable to U.S. citizens having the same filing status (in the case of a nonresident alien, at either single or married separate rates). It is immaterial whether the employee is or is not working in the United States at the time a bonus or unfunded deferred compensation is paid. The payments are considered U.S.-source effectively connected income no matter when received.[76] Note, however, that in some cases a treaty exemption may apply.

*c. Combined U.S.- and Foreign-Source Income*

If a nonresident alien is paid a bonus or unfunded deferred compensation for service in prior periods, the amount could be made up of both U.S.- and foreign-source income. For example, the individual might work for several years in the United States during which time the individual might travel on business outside the United States for part of the time. If after moving out of the United States and becoming a nonresident alien, the employer pays a bonus for the entire period of the individual's U.S. assignment, the bonus would be partly U.S.-source income and partly foreign-source income. The employer should prorate the bonus between the U.S.- and foreign-source portions with U.S. tax liability and wage withholding only on the U.S.-source portion (to the extent not exempt under a tax treaty), in accordance with the rules described in II.E.3.b., above. Note that the employee's resident or nonresident status seems to be relevant only at the time the payment is made. The fact that the alien may have been classified as a resident alien when the services were performed should not change the exemption for the foreign-source portion of the bonus if it is paid after the individual has become a nonresident alien.

*4. U.S. Citizen Recipient*

*a. Payment Is Foreign-Source Income*

Because a U.S. citizen is subject to U.S. tax on worldwide income, U.S. tax liability is often imposed on bonuses or unfunded deferred compensation paid to a U.S. citizen for services he or she has rendered abroad. However, both substantive tax liability and wage withholding tax may be reduced if the bonus is excluded under §911, or if the U.S. tax is reduced by foreign tax credits.

*(1) Section 911 Exclusion*

Depending on the size of the bonus, it may be excluded from the U.S. citizen's gross income under §911. If it is so excluded, wage withholding will not be imposed by reason of the exemption in §3401(a)(8)(A)(i), discussed in VI.A.1., below.

In determining whether a bonus is excludible under §911, the rules in §911(b)(1)(B)(iv) should be considered. That provision states that an item of deferred compensation may not be excluded if it is received later than the taxable year immediately after the services are performed. Section 911(b)(2)(B) provides further that if the bonus is excludible under §911, it is deemed to have been received in the taxable year in which the services were performed, and not in the year the bonus was paid. Thus,

[75] §862(a)(3), §864(c)(4), and §871(b).

[76] *See* §864(c)(6).



ISBN 978-1-61746-986-2

the bonus must be counted against the employee's dollar limitation under §911(b)(2)(A) for the year in which the services were rendered, and the other applicable rules for that year must also be applied.

*(2) No Section 911 Exclusion*

The bonus may not qualify for the §911 exclusion for any of a number of reasons, but the employee may have sufficient foreign tax credits to reduce or eliminate the U.S. tax on the bonus. This could occur either if the bonus is subject to foreign tax, or if it is exempt from foreign tax but the employee has excess foreign tax credits in the right separate limitation category for the current year or which were carried forward from a previous year.[77] For this purpose, the bonus would not relate back to the year in which the service was performed for a cash-basis taxpayer, but would be taxable only in the year received.

As discussed in VI.A.5., below, in calculating the amount of U.S. wage withholding tax (if any) on a bonus, the employer may consider foreign tax credits reflected on an employee's Form W-4 if the "mandatory flat rate withholding" rules do not apply and if the employer chooses the "aggregate" withholding tax method instead of the "optional flat rate" method. Alternatively, the employee may have given his or her employer a Form W-4 claiming exemption from U.S. wage withholding tax under §3402(n) (i.e., if he or she had no U.S. tax liability for the prior year and expects none for the current year).

*(3) Other Wage Withholding Exemptions*

The bonus may be exempt from wage withholding under some other exemption. For example, the bonus may be subject to foreign wage withholding. If so, the wage withholding exemption in §3401(a)(8)(A)(ii), discussed in VI.A.4., below, would apply.

*b. Payment Is U.S.-Source Income*

A bonus paid to a U.S. citizen for work done in the United States would not qualify for the §911 exclusion and U.S. tax ton the bonus could not be reduced by excess foreign tax credits or by the exception for foreign wage withholding tax. In the absence of a special wage withholding exemption in the §3401(a) definitions, therefore, the U.S.-source portion of a bonus would usually be subject to U.S. wage withholding.

*5. Resident Alien Recipient*

The rules governing the taxability of a bonus or unfunded deferred compensation paid to a resident alien are similar to the rules governing payments to U.S. citizens. Certain special problems may arise, however.

*a. Payment Is Foreign-Source Income*

If an employer pays a bonus to a resident alien employee for services rendered by the employee outside the United States (i.e., related to periods before the alien's move to the United States), the payment is fully taxable to the employee and would usually be subject to wage withholding. This is a common pitfall, which is avoidable if the bonus is paid while the employee is still a nonresident alien (*see* II.E.3.a., above). Because a cash-basis resident alien is taxed on worldwide income, however, the bonus is clearly taxable, probably without exemption from wage withholding under any of the exemptions in §3401(a). As a practical matter, however, if the employer is located in a foreign country, it is unlikely that it would comply with the U.S. wage withholding rules.

If the employee was also a resident alien during the period that he or she earned the bonus while working abroad, part or all of the bonus may be exempt from tax under §911, or by reason of excess foreign tax credits from the same year or a prior year. If this is the case, the rules described above concerning withholding on a resident alien's foreign-source income, would be applied.

*b. Payment Is U.S.-Source Income*

A resident alien who receives a bonus or unfunded deferred compensation for services rendered within the United States is generally taxed in full on such amounts, and the bonus is also subject to wage withholding.

*6. Funded Deferred Compensation Plans*

*a. Distributions from U.S. Qualified Plans*

A complete discussion of the substantive tax rules and the withholding rules applicable to funded deferred compensation is beyond the scope of this Portfolio. It should be noted, however, that under the rules of §3405, tax may be imposed on U.S. citizens and resident aliens at either wage withholding rates (in the case of periodic distributions from the tax-qualified U.S. trust), or at the rate of 25% (in the case of a lump-sum distribution from such a plan which is not rolled directly into another tax-qualified U.S. retirement plan). *See* II.C.7., above. In the case of a nonresident alien recipient, the rules are more complex, in that the distribution could be subject to partial wage withholding, partial 25% lump-sum withholding, partial 30% withholding under §1441, or partially tax-exempt, depending on the particular facts.[78]

*b. Plans Not Qualified Under U.S. Law*

Where an employer makes contributions to a funded plan which is not tax-qualified under U.S. law (§401 and following), the contributions are includible in the employee's gross income if the employee's rights in the plan are fully vested.[79] As such, the contributions are probably subject to U.S. wage withholding. If vesting does not occur until a subsequent taxable year, it is arguable that no wage withholding tax should be imposed at any time, although the vesting should probably be reported on Form W-2 at that time.

This problem arises in many situations in which contributions were made to a foreign funded plan for the account of a nonresident alien, a resident alien, or a U.S. citizen work-

[77] §904(c).

[78] *See* §31.3405(e)-1(f)(1) for a discussion concerning the applicability of §3405(a) and §3405(b) to a nonresident fact pattern.

[79] §83 and §402(b)(2); Reg. §1.402(b)-1. Under §402(b)(4), the increase in the employee's "vested accrued benefit" may also be taxable to him or her during the year, but it is unlikely that the employee's taxable income in this situation would be subject to wage withholding.



ISBN 978-1-61746-986-2

ing in the United States.[80] This is because an employee benefits plan that qualifies under foreign law rarely also meets the complex U.S. qualification rules as well. The §911 exclusion is not available with respect to income which is taxed to a U.S. citizen or resident as the beneficiary of a nonexempt employee benefits trust (*see* below). Therefore, contributions to such a plan made with respect to a resident alien or U.S. citizen working outside the United States would probably be taxable to the employee and subject to U.S. wage withholding as well, because.[81] However, U.S. tax and wage withholding could possibly be reduced or eliminated under one or more of the other exceptions discussed in VI.A. and VI.B., below.

*c. The Rules of Section 72(f)(2) and Section 72(w)*

Prior to the enactment of §72(w), a resident alien who received a payment from a foreign funding vehicle (such as a foreign pension trust) was generally exempt from U.S. tax on part of the payment. This is because the alien was permitted to calculate his or her "investment in the contract" (i.e., the individual's basis for U.S. tax purposes) as including contributions made to the fund by the employer that would not have been subject to U.S. tax if they had been paid to the alien directly as current cash compensation. Because the individual was typically a nonresident alien working outside the United States when the employer contributions were made, those contributions would not have been subject to U.S. tax if they had been paid to the individual directly. Thus, those contributions were included as part of the individual's investment in the contract. In addition, if the fund was part of a "top-up" plan for senior executives, the alien could also argue that he or she acquired additional basis in the fund with respect to the annual income earned by the portion of the fund allocable to his or her account in the plan, under §402(b)(4).[82]

In order to eliminate this perceived loophole, the American Jobs Creation Act of 2004 (2004 AJCA)[83] added §72(w) to the Code, which in effect denies basis to the individual with respect to any employer contributions that were made to the fund and that were not subject to either U.S. or foreign income tax when made, provided that the contributions would have been subject to income tax if they instead had been paid to the individual as cash compensation.[84] In addition, §72(w) also provides that the fund's earnings will not be included in basis unless they have also been subject to either U.S. or foreign income tax.

Because §72(w) does not require that foreign income tax have been paid at a prescribed minimum rate or higher, the new rule may still permit a benefit to be claimed under §72(f)(2) with respect to prior employer contributions if foreign income tax of some kind was paid during prior years but at a very low tax rate. Although employer contributions to an employee pension fund are usually exempt from income tax under most foreign income tax laws, some countries may impose employee social security tax on the contribution at a nominal rate. Under long-standing IRS rulings, an employee social security tax has been held to constitute an "income tax" in interpreting that term in the Code.[85] Unless the fund was subject to some kind of foreign income tax on its earnings, however, the individual could not include the fund's earnings as part of his or her investment in the contract for U.S. tax purposes.

The 2004 AJCA also made a similar amendment to §83, providing that rules similar to §72(w) will apply to deny basis to an individual who received salary in the form of property while working outside the United States as a nonresident alien. This no-basis rule will apply if it is shown that:

(1) no U.S. or foreign income tax was imposed on the value of the property at any time; and

(2) U.S. or foreign income tax would have been imposed if instead the payment had been made as "cash compensation."

*d. Special Section 911 Rules*

Section 911(b)(1)(B) contains a number of rules that deny the §911 exclusion to payments received by an individual in the form of funded or unfunded deferred compensation. These include payments received as a pension or annuity from either a funded plan (whether exempt or nonexempt under U.S. law) or on an unfunded basis, as well as amounts which are taxable prior to distribution under §402(b) and §403(c) because the fund does not qualify as tax-exempt under U.S. law. Although in many such cases such amounts would not be classified as wages subject to wage withholding under chapter 24, the employee would nevertheless be required to include such amounts in gross income.

*7. Equity-Based Compensation Plans (Stock Options, Etc.)*

A variety of fact patterns can arise in the case of stock options granted to employees in exchange for services. Thus, the rules outlined immediately below should be considered in light of:

(1) the employee's tax status (as a resident or nonresident alien, or as a U.S. citizen), and

(2) the substantive tax and wage withholding rules applicable to the source of any income that may arise.

When an employee exercises a nonstatutory stock option, the amount of the "spread" (excess of fair market value over exercise price) is includible in his or her gross income as "wages" subject to wage withholding.[86] Under the "multi-year compensation" sourcing rules in Reg. §1.861-4(b)(2)(ii)(F), income realized from the exercise of a stock option is generally sourced on the basis of where services were rendered between the date

[80] It should be noted, however, that an income tax treaty may provide relief if the individual and the non-U.S. employer satisfy the conditions set forth in the treaty.

[81] §911(b)(1)(B)(iii).

[82] *See* Thomas Bissell, *Application of Basis Rules to Nonresident Aliens,* in Tax Mgmt. Special Supp. on the 2004 American Jobs Creation Act, at 570 (Dec. 13, 2004).

[83] Pub. L. No. 108-357, §906(a).

[84] Thus, if the individual was resident in a country with no income tax law, §72(w) will not apply and the contribution will be included in the individual's investment in the contract under §72(f)(2).

[85] *See* 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

[86] Rev. Rul. 67-257. The payment would be eligible to be treated as supplemental wages subject to withholding at the optional 25% flat rate. Rev. Rul. 66-190; Rev. Rul. 66-294.



ISBN 978-1-61746-986-2

the option rights were granted and the date on which they vested, although different source rules may apply, depending on the facts and circumstances of the particular grant.

Similarly, the amount received by an employee from an employer upon the cancellation of a nonstatutory stock option that had no readily ascertainable market value at the time of grant is includible in the employee's gross income and is also classified as wages subject to withholding.[87] The IRS has also ruled that where an employer contributes its stock to a nonqualified stock purchase plan, the fair market value thereof (in excess of any employee contributions) is includible in gross income and is classified as wages subject to withholding.[88]

When an employee acquires stock pursuant to a qualified plan and subsequently makes a nonqualifying disposition of such stock, §421(b) provides that no wage withholding is imposed on the amount realized by the employee.

When an employee participates in a restricted stock plan subject to §83, the IRS has ruled that when the "substantial risk of forfeiture" conditions lapse and the employer transfers stock to the employee, the fair market value of the stock (less any amount paid by the employee) is subject to wage withholding.[89] The IRS ruled in PLR 8711107 that gross income from the receipt by an employee of restricted stock is sourced on the basis of where the employee performed services starting on the date the restriction period began, and ending on the date on which it ended.[90] The ruling only discusses how to apply this general rule to alien individuals (with examples of nonresident aliens who become resident aliens during the restriction period, resident aliens who become nonresident aliens during the restriction period, and nonresident aliens who remain nonresident aliens throughout the restriction period). However, the same rules presumably apply to individuals who are resident aliens or U.S. citizens throughout the restriction period, with respect to both the employee's substantive tax liability and the obligation on the part of the employer to withhold under §3401.

Restricted stock units (RSUs) issued by an employer as renumeration for services performed by a U.S. citizen or resident employee constitutes taxable income for purposes of §3401(a). RSU income is subject to withholding at the time that it is actually or constructively paid.[91]

### *F. Estimated Tax Requirements of Individuals*

Even though an individual may be subject to wage withholding tax on wages received as an employee, he or she may also be required to make payments of estimated tax under §6654. Estimated tax may be payable if the employee receives investment income, or if the wage withholding tax on his or her salary under the wage withholding tables is insufficient to cover his or her tax liability.[92]

The question of estimated taxes can be especially important in a cross-border context. For example, a nonresident alien who moves to the United States may not have wage withholding tax withheld from his or her salary during his or her initial months, and he or she did not make estimated tax payments. The exception of §6654(e)(2) relating to the employee's prior-year tax liability will not be available to him or her because the individual will not have been a U.S. citizen or resident alien during all of the preceding year, as required by the statute. Similar problems can arise for U.S. citizens and resident aliens returning to the United States from abroad.

### *G. Crediting of Wage Withholding Tax and Estimated Tax by the Individual*

All amounts of wage withholding tax with respect to an individual taxpayer, and all estimated tax payments, are claimed as credits against the taxpayer's final tax liability on the return.[93] To the extent that the total of such payments exceeds the taxpayer's tax liability for the year, a refund of such excess may be claimed.

### *H. Penalties for Underwithholding of Section 3402 Tax*

An employer who fails to withhold from the wages of an employee, or who withholds less than the amount prescribed by §3402 and the regulations thereunder, is exposed to interest and penalties. These rules are described further in XIII., below.

An important rule in §3402(d) is that interest and penalties may be imposed on an employer even if the employee subsequently pays the full amount of the federal income tax on his or her wages. However, §3402(d) makes clear that in this case the employer is relieved of liability to pay the wage withholding tax itself.

### *I. Issuance of W-2 Reporting at Year-End*

As discussed further in XIII., below, §6051(a) requires most employers to furnish Forms W-2 to their employees after the end of the year to report wages that were subject to wage withholding tax, and to file a copy of each Form W-2 with the Social Security Administration (SSA) together with a summary on Form W-3. The statute, the regulations, and instructions to Form W-2 and Form W-3 are unclear on the extent to which compensation must be reported if it is excluded from the definition of wages in §3401(a). In general, the regulations seem to require compensation that is exempt from wage withholding to be reported if there is a reasonable possibility that the particular item could be included in the employee's gross income under §61 and thus subject to substantive tax liability. This approach is clearer in some of the IRS's more detailed publications on particular kinds of employment. For example, in Publication 15-A, *Employer's Supplemental Tax Guide,* in the discussion of "religious exemptions," it is stated that salary of an ordained minister that is exempt from wage withholding under §3401(a)(9) should nevertheless be reported on Form W-2 (presumably because it is included in the employee's gross income under §61), but not a parsonage allowance (presumably because it is not only excluded from wage withholding, but also excluded from the employee's gross income under §107).

[87] Rev. Rul. 67-366.

[88] Rev. Rul. 78-185.

[89] Rev. Rul. 79-305.

[90] The planning possibilities under §83(b) for certain nonresident aliens are discussed in Thomas Bissell, *Section 83(b) Elections by Nonresident Aliens,* 42 Tax Mgmt. Int'l J. 417 (July 12, 2013).

[91] *See* §31.3401(a)-1(b). *See also* CCA 202327014.

[92] For a discussion of the estimated tax rules that affect individuals, *see* 581 T.M., *Estimated Tax* (U.S. Income Series).

[93] §31(a), §6315.



ISBN 978-1-61746-986-2

In an international context, therefore, an employer may want to take a conservative approach with respect to various types of compensation that may be exempt from wage withholding but which might nevertheless be included in the employee's gross income. As discussed further below, in the case of U.S. citizens and resident aliens working abroad, this would suggest that salary that is exempt from wage withholding because the employee expects to satisfy the §911 exclusion (and has given his or her employer the required Form 673) should nevertheless be included on the employee's Form W-2 because of the possibility that the employee might not satisfy the §911 exclusion rules. On the other hand, in the case of a native of Puerto Rico who has always resided and worked there and who claims the §933 exclusion for Puerto Rican-source income, it might be excessive for the employer to give him or her an IRS Form W-2 to report salary that is excluded under §3401(a)(8)(C) (the wage withholding exclusion for Puerto Rican residents who expect to satisfy the §933 exclusion rules), especially since the equivalent of Form W-2 will be filed by the employer with the Puerto Rican tax authorities under Puerto Rican law.

In the case of a nonresident alien employee based in the United States who periodically works outside the United States, the portion of salary allocable to non-U.S. workdays is excluded from wage withholding under the §3401(a)(6) regulations. As discussed in V.A., below, however, the payroll departments of most employers presumably withhold on the employee's total salary without adjustment for non-U.S. workdays. Even if the employer does have the capability of tracking non-U.S. workdays, it may choose not to do so because of the possibility that the employee could actually be classified as a resident alien for the year under the "substantial presence" test of §7701(b)(1)(A)(ii), or that he or she might make a resident alien election for the year under §6013(g) or §6013(h). In any of these situations the employee's salary for non-U.S. workdays will be included in his or her gross income under §61. Whether or not the employer does track the employee's non-U.S. workdays for wage withholding tax purposes, it may nevertheless want to report the employee's gross salary on Form W-2, again because of the possibility that the employee may actually be a resident alien.

Finally, it should be noted that where a foreign employer may technically be required to furnish an employee with a Form W-2 to report certain items of compensation but chooses not to do so because it has no U.S. presence, many companies arrange for the compensation items to be shown on the Form W-2 that a related U.S. company gives to the same employee. For example, if a U.S. citizen works abroad and receives part of his or her compensation from a U.S. parent company and part from a foreign subsidiary, the U.S. parent may decide to add the salary paid by the foreign subsidiary to the salary paid by itself and to show the combined amount in box 1 of the Form W-2 that the U.S. parent gives to the employee. A similar issue may arise where a foreign company pays either current salary or deferred compensation to a resident alien who is working temporarily in the United States, and where the individual receives most of his or her current salary from a related U.S. company. In that situation the U.S. employer may decide to show the total compensation paid by both companies on the Form W-2 that it gives to the employee.

Whether or not an employer is required to withhold and/or to deposit wage withholding tax and/or FICA with respect to any of its employees, it may nevertheless be required to report remuneration paid by it on quarterly Form 941. *See* the further discussion in XIII., below.

### *J. Wage Withholding on Behalf of "Disregarded Entities"*

Treasury regulations have provided since January 1, 2009, that an entity that is classified as a disregarded entity for U.S. tax purposes under the check-the-box regulations is nevertheless treated as a stand-alone entity for FICA and other U.S. employment tax purposes.[94] This means that if a foreign company is a disregarded entity, then it — and not the person that owns it — is treated as the employer of its employees for FICA purposes. This is true even though for U.S. corporate income tax purposes the entity is treated as a branch of its owner (i.e., as an integral part of its owner). The wage withholding implications of these regulations for employees working outside the United States for a U.S.-owned disregarded entity are discussed further in VI.E., below.

### *K. Employer Appointment of Authorized Agent (Form 2678)*

Section 3504 provides that an employer may formally appoint an agent to act on its behalf in complying with all federal employment tax rules (i.e., with the Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and wage withholding rules). Form 2678 is used for this purpose. This arrangement is voluntary on the part of the employer; thus, an employer cannot be compelled by the IRS to enter into an agency relationship with another person. At the same time, if an employer does not execute Form 2678 with another person that acts as its agent, presumably the *de facto* agent cannot be exonerated from compliance with the wage withholding rules, to the extent that they apply to an agent. As discussed below, for example, if an agent has custody over salary that is paid to the employer's employee, the agent could be required to withhold and deposit withholding tax from the funds in its custody, and to do the required IRS filings.

*Comment:* When a foreign employer may be subject to wage withholding but may not have a U.S. payroll system in place, the employer should consider the possibility of executing Form 2678 with an agent that will comply with the U.S. rules on the employer's behalf. Although executing Form 2678 will not exonerate the employer from its wage withholding (and other U.S. employment tax) obligations under the Code, if the agent is experienced in dealing with other foreign employers, executing Form 2678 could save the employer substantial time in trying to do the compliance itself, and also provide it with assurance that the compliance is likely to be done correctly.

### *L. Special Rules for U.S. Citizens, Resident Aliens, and Nonresident Aliens*

#### *1. U.S. Citizens*

Although U.S. citizens working within the United States are generally subject to wage withholding tax unless they work

[94] Reg. §301.7701-2(c)(2)(iv)(B).



ISBN 978-1-61746-986-2

in employment that is exempt from withholding, §3401(a)(8) contains five specific exceptions for U.S. citizens working outside the United States. These exceptions cover:

(i) Remuneration which is expected to be excluded under §911 (§3401(a)(8)(A)(i));

(ii) Remuneration which is subject to wage withholding tax under the laws of a foreign country or a U.S. possession (§3401(a)(8)(A)(ii));

(iii) Remuneration for work done in a U.S. possession which is expected to be excluded under §931 (§3401(a)(8)(B));

(iv) Remuneration for work done in Puerto Rico which is expected to be excluded under §933 (§3401(a)(8)(C)); and

(v) Remuneration paid for services performed for the United States or any of its agencies within a possession to the extent the United States or its agency withholds taxes on that remuneration for the account of the possession pursuant to an agreement with the possession. (§3401(a)(8)(D)). (The purpose of this provision is to provide that wage withholding tax on the salaries of U.S. government employees working in a U.S. possession is deposited with the possession, where the employees' substantive tax liability is to the possession and not to the United States). Because this rule is of limited scope, it will not be discussed further in this Portfolio.

To the extent that remuneration for work done outside the United States may not be excluded under one of these rules, a partial or complete exemption from wage withholding tax may nevertheless be available in practice under one of several additional rules, discussed in VI.A., below.

*2. Resident Aliens*

Whether an individual is a "resident alien" or a "nonresident alien" is governed by the detailed rules in §7701(b). While a detailed discussion of those rules is beyond the scope of this Portfolio, a summary of the rules is contained in I.C.2., above. A detailed discussion of these rules is found in 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals.*

Although resident aliens are generally subject to wage withholding tax on remuneration for work done within the United States, the rules that apply to resident aliens working outside the United States are more complex. One problematic aspect of §3401(a)(8) is that it only covers U.S. citizens working outside the United States, and not also resident aliens. As indicated above, §3401(a) technically defines wages to include all remuneration paid by every employer in the world to every employee, subject to a number of exceptions. The statute's silence in the case of resident aliens means that remuneration paid to resident alien employees is technically subject to wage withholding tax in many situations in which remuneration paid to a U.S. citizen would be exempt from withholding tax.

For example, resident aliens are eligible for the §911 exclusion based on "physical presence" in one or more foreign countries for 330 days in a 12-month period, within the meaning of §911(d)(1)(B). Because §3401(a)(8)(A)(i) contains no exception for resident aliens but only mentions U.S. citizens, an employer is technically required to withhold tax from remuneration paid to a resident alien who is entitled to the exclusion. Similar problems arise with respect to resident aliens whose remuneration is subject to wage withholding tax under the laws of a foreign country. However, a resident alien would be entitled to reduce his or her wage withholding tax in the same manner as a U.S. citizen to reflect expected foreign tax credits.

These problems are discussed further in VI.B., below.

*3. Nonresident Aliens*

Section 3401(a)(6) provides that remuneration for services performed by a nonresident alien individual are exempt from the definition of wages to the extent designated by regulations. These regulations, which are contained in Reg. §31.3401(a)(6)-1, distinguish between remuneration paid for services performed by a nonresident alien outside the United States and services performed within the United States. Remuneration for services performed outside the United States is exempt from the definition of wages in all situations.

Remuneration for services performed by a nonresident alien *within* the United States is generally classified as wages (provided that none of the other exceptions in §3401(a)(1)–§3401(a)(23) apply), with the exception of work done by certain transportation workers resident in Canada and Mexico, certain nonresident alien crew members of foreign vessels engaged in international transportation, and, more broadly, by nonresident alien employees who are entitled to a federal income tax exemption or an income tax treaty exemption. These exceptions are discussed further in V.B., below.

### *M. Foreign Employer with No U.S. Contacts*

*1. Exposure to Tax*

Because the definition of wages in §3402(a) includes remuneration paid to all employees in the world unless specifically excepted, an employer is at least theoretically subject to the U.S. wage withholding requirements even though it has no office or assets within the United States and no employees working at any time within the United States.

For example, if a U.S. citizen works outside the United States for a temporary period of time and his or her remuneration is not exempt from withholding tax under any of the exceptions in §3401(a)(8) (outlined in II.D.2., above), that U.S. citizen's employer is subject to wage withholding tax even though the employer may be a foreign corporation and which has no U.S. office or assets. Similarly, if a nonresident alien works for a short period of time in the United States on a business trip for a foreign employer and is not exempt from U.S. tax on his or her salary under the Code or under a tax treaty, the employer is subject to the U.S. wage withholding tax rules.

The wage withholding tax rules thus mirror an extremely important concept that also applies in computing an employee's personal tax liability. As a general rule, an employee receiving wages is subject to personal income tax based on where his or her services are performed, and in most cases the place where his or her employer is resident or has an office is not relevant, nor is the place where payment may be received. Thus, an employee from a non-tax treaty country who receives wages for work done in the United States is usually subject to personal income tax liability, and his or her employer is subject to wage withholding tax, because the services are performed by the employee within the United States. In such a situation, the fact



ISBN 978-1-61746-986-2

that the employer may have all its offices and assets outside the United States, and be foreign-incorporated and foreign-owned, is usually disregarded. Similarly, the fact that the wages may be paid into a foreign bank account of the employee is always disregarded.

*2. Disbursing Agent Subject to U.S. Jurisdiction*

In order to assist the IRS in enforcing collection of wage withholding tax generally, §3401(d)(1) defines an "employer" to include not only the person for whom the employee's services are actually performed, but also any person who has control over the payment of the employee's wages. Section 3401(d)(2) provides further that the term employer includes any person paying wages on behalf of a foreign employer that is "not engaged in trade or business within the United States."[95] While this rule clearly embraces disbursing agents that are separate from the true employer and located outside the United States, an obvious effect of this rule is to give the IRS authority to collect from any person within the United States who acts as a disbursing agent for a foreign employer which otherwise has no U.S. contacts. Thus, §3401(d) would give the IRS jurisdiction to collect the tax from a U.S. agent who disburses salaries to employees in both of the situations described immediately above in II.M.1.

[95] *See* Reg. §31.3401(d)-1(e), §31.3401(d)-1(f).



ISBN 978-1-61746-986-2

## III. U.S. Income Tax Withholding and Reporting on Self-Employed Individuals — General Structure

### *A. Relevant Issues for the Payor of Remuneration for Services*

In certain cases when a self-employed individual provides services to another person, the Code imposes withholding and reporting requirements on the person who pays (the payor) the self-employed individual (the payee). Although those rules are often less burdensome than the withholding and reporting requirements that are imposed on employers who make payments to employees, the payor should remain aware of those rules. This section outlines the issues that are important for payors that make payments to self-employed individuals in an international context, and then outlines the rules that apply to the three categories of individuals who earn self-employment income in return for services that are provided either within the United States or outside the United States.

#### *1. Is the Individual an Employee or Self-Employed?*

Where an individual provides services in return for compensation, the individual is classified as either an "employee" or as an "independent contractor." As discussed in II.A., above, this determination is made on the basis of objective rules in the Code and in the regulations, and for most individuals it cannot be changed through the making of an election. Because the tax withholding and IRS reporting rules that are imposed on the person who receives the services are very different, it is critical that the payor determine whether the payee is an employee or an independent contractor. In most cases it should be possible for the payor to make this determination without difficulty.

#### *2. Payee's Status as a U.S. Citizen, Resident Alien, or Nonresident Alien*

In an international context, it is also important for the payor to know whether the payee is a U.S. citizen, and if the payee is a not a U.S. citizen, whether the payee is a resident alien or a nonresident alien for U.S. income tax purposes. As discussed in VI.D., X., and XI., below with respect to individuals working outside the United States, one of the gaps in the applicable tax rules is that in many cases the payor cannot be certain of the payee's status, even though the payor may have made a good faith effort to find out. The result may be that the payor could be at risk for IRS penalties despite the payor's due diligence. As a practical matter, however, the IRS's ability to enforce these rules is limited in several of the most typical international situations.

#### *3. Where Are the Services Performed?*

In an international context, it may also be important to know whether the services were performed by the payee within the United States, outside the United States, or both within and outside the United States. Thus, the payor could be exposed to potential IRS penalties if the payee performed services within the United States but the payor believes that they were performed outside the United States.[96] Unfortunately, the payee's self-employment status would usually mean that the payor had little or no "control" over the payee's activities and therefore may not know where the services had been performed, particularly with the rise of remote working and "digital nomads." While this risk is frequently present, it is unclear how a payor or the IRS can successfully determine where the services were actually performed when remote working is involved.

#### *4. Is the Payor Engaged in a Trade or Business?*

As discussed below, this issue is important where the payee is a U.S. citizen or resident alien, because if the payor is not engaged in a trade or business with respect to the payments that are made to such a payee, it is unlikely that any U.S. withholding or information reporting is required under the Code. If the payor is engaged in a trade or business, there is likely to be a withholding and/or reporting requirement with respect to payments made to a U.S. citizen or resident alien even if the payee rendered the services outside the United States (unless the payor is a foreign person). Although the determination of whether a payor is engaged in a "trade or business" can be extremely subjective under the Code, in most cases the payor should know whether he, she, or it is in fact engaged in a trade or business for U.S. tax purposes with respect to the payment that is being made to the payee. (If the payee is a nonresident alien who renders services within the United States, it does not matter whether the payor is engaged in a trade or business, or that the payment may not be connected with a trade or business that the payor happens to have.)

#### *5. Is the Payor a U.S. Person or a Foreign Person?*

With one exception — payment made "outside the United States" by a foreign person for services rendered outside the United States — it does not matter whether the payor is a U.S. person or a foreign person. For example, if a foreign corporation engaged in a trade or business makes payments to a self-employed individual for services rendered in the United States, but the foreign corporation is not engaged in a trade or business within the United States and has no other contacts with the United States, it may nevertheless be required to comply with the applicable U.S. withholding and reporting rules.

#### *6. Distinction Between Section 1441 and Section 3406 Withholding*

In determining whether the payor must withhold tax from payments made to a self-employed payee, there are two parallel sets of rules, based on the status of the payee as a foreign person or a U.S. person. If the payee is a nonresident alien, withholding the flat rate of 30% is usually required under §1441 on the portion of the payment that is U.S.-source (i.e., the portion that represents payment for services rendered within the United States), but the foreign-source portion is exempt from withholding. If the payee is a U.S. citizen or resident alien *and* if

[96] In the reverse situation it is unlikely that the payor could be exposed to penalties. Thus, if the payor believed that the services were rendered within the United States but they were actually rendered outside the United States, a properly advised payor would usually comply with the applicable U.S. withholding and/or reporting requirements for U.S.-source services. In many cases this could result in overwithholding, but if that happened, the payee would be entitled to claim a refund of the overwithheld tax. The payor, however, almost always would be protected from any IRS penalties in the event that overwithholding did occur.



ISBN 978-1-61746-986-2

the payor is engaged in a trade or business, the "back-up withholding" rules of §3406 may be applied, but only if the payee does not provide the required information about himself or herself to the payor. These two withholding provisions are outlined briefly immediately below.

### *B. Backup Withholding Rules of Section 3406*

To understand the backup withholding rules of §3406,[97] it is first necessary to understand §6041 and §6041A, because a self-employed individual who renders services is generally not subject to potential backup withholding unless the payor is otherwise required to provide the individual with an IRS reporting form at the end of the year under either or both of these Code sections.

#### *1. Background of Section 6041 and Section 6041A*

##### *a. General Rules*

Persons "engaged in a trade or business" that make payments of wages, service fees, and other items of income to individual recipients are subject to an elaborate system of information reporting where the amounts total $600 or more in the taxable year. The rules governing payments for services are contained in §6041 and §6041A and the regulations thereunder. Where reporting is required under these sections, the applicable form is IRS Form 1099-MISC. Other sections of the Code deal specifically with forms in the 1099 series with respect to interest, dividends, and other more specialized items. Of historical interest is the fact that the broad language in §6041(a) itself reads similarly to that of §871(a)(1)(A) and §881(a)(1), by requiring information returns with respect to "salaries, wages, premiums, annuities, compensations, remunerations, emoluments, *or other fixed or determinable gains, profits, and income* …" (emphasis added).

The language of §6041A, enacted in 1982, overlaps considerably with §6041 itself, which is much older. With respect to compensation for services paid to an individual, it is understood that if the regulations under one of these sections provides an exemption, that exemption is usually effective with respect to the other section as well.

If a payor fails to file Form 1099-MISC as required by §6041 and §6041A, penalties may be imposed under §6721. As discussed further below, backup withholding under §3406 may be imposed if the payee has failed to furnish the payor with his or her social security number and other required information.

##### *b. All Payments for Services Potentially Covered*

The extremely broad language in §6041(a) and §6041A means that all compensation for services are potentially subject to the reporting requirements, unless specifically exempted by the regulations or by ruling. Thus, remuneration paid to an employee is potentially subject to reporting, as are payments for services made to self-employed independent contractors. Because neither section has any jurisdictional limits, technically the reporting requirements also apply to compensation for services paid between any two persons anywhere in the world, but subject to the special exception noted above.

##### *c. Payor Must Be Engaged in a Trade or Business*

The payor must be engaged in a trade or business (although not necessarily within the United States) in order for reporting to be required. For example, if a service fee is paid to a domestic servant working as an employee in a private household, no reporting is required.

##### *d. Payments Must Total $600 or More*

Total payments made by the particular payor to the particular payee for the year must be $600 or more.

##### *e. Payee Must Be an Individual*

Reg. §1.6041-3(p)(1) and Prop. Reg. §1.6041A-1(d)(2) provide for an exception in the case of payments made to a corporation, except for certain medical care payments or attorney fees.

##### *f. Treatment of Employees*

To the extent that remuneration paid to an employee is required to be reported on Form W-2 (i.e., wages under §3401(a), or subject to the Federal Insurance Contributions Act (FICA) tax) no reporting is required under §6041(a). Section 6041A(c), Reg. §1.6041-3(a), and Prop. Reg. §1.6041A-1(d)(1) provide that amounts required to be reported by an employer on Form W-2 are exempt from reporting on Form 1099-MISC.

##### *g. Exception for Certain Nonresident Aliens*

The regulations under §6041 and §6041A provide in effect that reporting is not required with respect to payments made to nonresident aliens that are reportable under §1441.[98]

##### *h. Global Scope of Section 6041 and Section 6041A*

Section 6041(a) and §6041A technically impose a reporting requirement on all persons in the world who are engaged in trade or business and who pay remuneration for services totaling $600 or more to another person. Thus, the statute without limitation imposes the requirement on "all persons engaged in a trade or business" who make payments in the course of such trade or business to "another person" (or "any person") of remuneration for services totaling $600 or more. As described further in X. and XI., below, however, the IRS administratively has placed territorial limits on the scope of §6041(a), and the proposed regulations under §6041A expressly deal with the issue.

#### *2. "Reportable Payments" Under Section 3406*

In the case of remuneration for services paid to a self-employed individual, §3406 requires the payor of a "reportable payment" to impose backup withholding tax at the rate of 24% if the payee does not provide the payee with his or her taxpayer identification number on a timely basis. Section 3406(b)(3) defines the term reportable payment to include payments that are required to be reported by the payor under §6041 or §6041A(a). In most cases the information is provided to the payor by the

[97] For further details on the backup withholding rules of §3406, *see* 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series).

[98] *See* Reg. §1.6041-4(a)(1), §1.6041A-1(d)(3)(i)(A).



ISBN 978-1-61746-986-2

payee on IRS Form W-9. If the payment is not required to be reported by the payor to the IRS under §6041 or §6041A, however, then the backup withholding rules do not apply.

As discussed above, backup withholding does not apply to wages paid to an employee that are required to be reported on Form W-2. Nor does it apply to remuneration for services paid to a nonresident alien where the payment is subject to §1441 and is thus required to be reported to the IRS on Form 1042S. In addition, payments for the year that total less than $600 are generally exempt from reporting under §6041 or §6041A.[99] Finally, backup withholding clearly does not apply if the payor is not engaged in a trade or business with respect to the payment that is made to the payee, because in that situation the payor is not required to report the payment to the IRS under §6041 or §6041A.

### C. *Nonresident Alien Withholding Under Section 1441*

Where a nonresident alien individual performs services in the United States as an independent contractor rather than as an employee, a separate set of withholding rules applies. Because the individual is not an employee of the service recipient, the wage withholding rules of chapter 24 of the Code do not apply, and instead the compensation for services paid to the individual are subject to withholding at the flat rate of 30% under §1441, because such compensation is considered to be "fixed or determinable annual or periodical" (FDAP) income, as described therein. As discussed further below, however, the rules governing substantive tax liability are more complex, because the fees are almost always taxed at graduated personal income tax rates as "effectively connected" income under §871(b).

Withholding under §1441 is not imposed on amounts paid to a nonresident alien to the extent that services were performed *outside* the United States, because that portion of the fees is classified as foreign-source income under §862(a)(3), and thus is neither taxed to the nonresident alien under §871 nor subject to withholding under §1441.

As noted above, because U.S.-source remuneration for services paid to a nonresident alien are subject to withholding under §1441 and reporting under §1461, they are exempt from reporting under §6041 and §6041A. Thus, they cannot be classified as "reportable payments" that are potentially subject to backup withholding under §3406. As discussed further in XI., below, technically service fees paid to a nonresident alien for services rendered *outside* the United States could possibly be classified as a "reportable payment" under §3406 because there is no express exception in §6041 or §6041A for reporting *foreign*-source payments to nonresident aliens. However, the regulations under §6041 and §6041A appear to exempt such payments from Form 1099-MISC reporting.

### D. *Overview of U.S. Income Tax Withholding and Reporting on Payments to Independent Contractors*

This section outlines the U.S. income tax withholding and reporting rules that apply to payments made to self-employed workers in an international context. These rules will be discussed in greater detail in sections VIII. through XI., below.

#### 1. *U.S. Citizens and Resident Aliens Working in the United States*

Because payments to these individuals are not subject to §1441 withholding or reporting, they are "reportable payments" under §3406 if the payor is engaged in a trade or business and if the payments exceed the $600 threshold. Thus, they could be subject to backup withholding if the payee does not provide the payor with Form W-9. These rules are discussed further in VIII., below.

#### 2. *Nonresident Aliens Working in the United States*

Payments made to a nonresident alien for services rendered within the United States are U.S.-source income and are subject to 30% withholding under §1441 and are generally reportable on Form 1042S under §1461 (depending on the particular facts, an income tax treaty may provide for exemption from the 30% tax). Thus, they are exempt from reporting under §6041 and §6041A, and are exempt from potential backup withholding under §3406.

As discussed further in IX., below, withholding under §1441 is required even if the payor is *not* engaged in a trade or business.

#### 3. *U.S. Citizens and Resident Aliens Working Outside the United States*

As discussed in X., below, remuneration for services paid to self-employed U.S. citizens and resident aliens working outside the United States may be required to be reported under §6041 and/or §6041A, depending on the precise facts. If the regulations require the particular payment to be reported under §6041 or §6041A, it is thus a "reportable payment" subject to backup withholding under §3406 unless the payee provides Form W-9 to the payor.

#### 4. *Nonresident Aliens Working Outside the United States*

Amounts paid to self-employed nonresident aliens for services rendered entirely outside the United States are clearly not subject to §1441 withholding or reporting. Thus, if they are paid by a person engaged in a trade or business, technically they could be subject to reporting under §6041 and/or §6041A, and thus potentially subject to backup withholding under §3406. However, because the purpose of both the reporting rules of §6041/§6041A and of the backup withholding rules is to enforce the reporting of the service fees by the payee on his or her U.S. income tax return (typically, on Form 1040), there is no purpose in requiring reporting and/or withholding of foreign-source service fees paid to a nonresident alien, because such fees are never subject to substantive U.S. income tax liability under §871. For this reason, the IRS has apparently provided administratively that foreign-source service fees paid to nonresident alien individuals are exempt from reporting under

[99] The backup withholding regulations in Reg. §31.3406(b)(3)-1(b)(3)(ii) contain a special exception, however, that classifies a payment as reportable even if the $600 threshold is not met during the current year, provided that payments to the same payee were required to be reported to the IRS for the preceding year under §6041 or §6041A, or the payor was required to do backup withholding with respect to that payee for the preceding year.



ISBN 978-1-61746-986-2

§6041 and §6041A, and thus exempt from backup withholding under §3406 as well. This issue is discussed further in XI., below.

### *E. Reimbursement of Expenses*

#### *1. In General*

Where a self-employed individual's client or customer provides reimbursement for some of the individual's expenses (for example, travel and entertainment expenses, or other business expenses), the reporting and withholding rules are based on the same accountable plan rules that apply in an employer-employee situation (discussed in II.D.4.b., above). Although the regulations under §6041 and §6041A do not specifically discuss the reimbursement of a self-employed individual's expenses, the IRS confirms in Publication 463, *Travel, Gift, and Car Expenses*, that "[i]f the contractor [i.e., the self-employed payee] adequately accounts to you [the payor] for reimbursed amounts, you don't have to report the amounts on an information return."

It is unclear whether this rule applies if the compensation for services paid to the payee is required to be reported to the IRS under §6041 or §6041A but the payee does not provide documentation or information to the payor, with the result being that the compensation for services itself is subject to backup withholding under §3406. In practice, however, this is a very unusual situation. If the relationship between the payor and the payee is close enough that the payor has agreed to reimburse the payee under an "accountable plan" that satisfies §62(c), it is likely that the payee would have provided whatever documentation is necessary in order to not be subject to backup withholding on the compensation for services.

Whether or not the payor reports the reimbursement to the IRS or withholds on the payment (under either §1441 or §3406), the self-employed individual's substantive tax liability with respect to the reimbursement is the same, with one important exception. Thus, a self-employed individual is entitled to claim the same deductions as an employee for business expenses (including, if applicable, so-called tax home expenses). However, the deductions would be without the 2%-of-AGI limitation that applies to an employee whose deductible expenses are subject to wage withholding and shown on Form W-2 for the reason that they are not paid pursuant to an accountable plan. Thus, there is little or no downside for a self-employed individual whose expenses are reimbursed but not through an accountable plan,[100] because the self-employed individual may claim these expenses on his or her tax return (typically on Schedule C and/or Form 2106, *Employee Business Expenses*).

#### *2. Nonresident Alien Payees*

Although the §1441 regulations do not discuss the reimbursement of a self-employed nonresident alien's expenses by the individual's client or customer, the IRS in a General Information Letter issued in 1998 stated that the accountable plan rules do in fact apply in this situation.[101] In the facts described in the letter, a tax-exempt university reimbursed the expenses of nonresident alien guest lecturers who were not employees of the university for U.S. tax purposes. The IRS stated that the reimbursements were not subject to IRS reporting or withholding (presumably under §1441), provided that the payor and the payee both satisfied the requirements of the accountable plan rules.

#### *3. Reimbursements Made Without an Accountable Plan*

If a client or customer does reimburse some or all of a self-employed individual's expenses but the reimbursement does not satisfy the "accountable plan" rules, the reimbursement should be treated in the same manner as any other compensation for services. In determining whether reporting and/or withholding is required with respect to the reimbursements, therefore, the rules discussed in VIII. through XI., below, should be applied.

### *F. Deferred Compensation for Self-Employed Individuals*

Although it is less common for the recipient of services from a self-employed individual to arrange to pay for part or all of those services in the form of deferred compensation like that which occurs between an employer and an employee, when this happens the general rules that apply to current compensation are applied, but subject to most of the same rules that apply with respect to deferred compensation for employees. The following is a brief summary of the rules.

#### *1. In General*

Deferred compensation that is promised (and eventually paid) to a self-employed individual in principle is subject to the special rules of §409A, except that the regulations provide for an exception where three tests are met:

(1) the self-employed individual is actively engaged in the trade or business of providing services (other than as an employee or a board member of a corporation);

(2) he or she provides significant services to two or more clients or customers who are not related; and

(3) he or she is "not related" to the client or customer, as specially defined.[102]

These exceptions are not available, however, if the self-employed individual provides "management services" to the customer or client.[103]

Provided that §409A does not apply to a particular deferred compensation arrangement between a self-employed individual and the client or customer, there is apparently no reporting or withholding obligation on the part of the payor until payment actually takes place. If §409A does apply, the payor may at its election report the amount of the deferred compensation in box 15 on Form 1099-MISC (if the self-employed service provider is a U.S. citizen or resident alien), but for the time being reporting is apparently not mandatory.[104]

---

[100] Therefore reported to the IRS and possibly even subject to withholding under §1441 or §3406.

[101] *See* December 16, 1998, IRS Letter to Coopers & Lybrand, LLP, Regarding Whether Withholding Agent Is Required to Withhold Tax on Reimbursed Expenses Paid to Nonresident Alien Guest Lecturers, reproduced in Worksheet 5 of 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers.*

[102] Reg. §1.409A-1(f)(2).

[103] Reg. §1.409A-1(f)(2)(iv).

[104] *See* the instructions to Form 1099-MISC.



ISBN 978-1-61746-986-2

When the deferred compensation is paid, however, it is subject to reporting and/or withholding in accordance with the rules that apply to current compensation, described in VIII. through XI., below. In applying those rules, the payee's status on the date of payment (as a U.S. citizen, resident alien, or nonresident alien) determines whether the provisions of §6041, §6041A, and §3406 should apply (for U.S. citizens and resident aliens), or whether §1441 should apply (for nonresident aliens). The place where services were performed by the payee should also be taken into account, if that fact is relevant. For example, if all of the services were performed outside the United States and if the payee is a nonresident alien on the payment date, no withholding under §1441 would be required. However, if the payee is a U.S. citizen or resident alien on the payment date but was a nonresident alien when the services were performed outside the United States, reporting and possibly backup withholding may be required in accordance with the rules discussed in X., below.

*2. Equity-Based Compensation*

Where the customer or client of a self-employed individual is a corporation that compensates the individual with some form of rights to equity in the corporation, the general principles that apply to equity-based compensation of an employee would apply. Thus, if the payor provides rights to purchase stock in the payor at a bargain price, the payee would usually realize gross income only upon the exercise of the option rights. The individual's U.S. tax status on the exercise date would determine the extent to which reporting and/or withholding was required under §6041/§6041A, §3406, and §1441, and the source of the income would be determined with reference to where services were performed (i.e., within the United States or outside the United States) between the grant date and the exercise date. If the payor provides the payee with restricted stock rights, rules similar to those described above for employees would be applied.

### *G. FATCA Rules Under Section 1471 – Section 1474*

The 2010 HIRE Act[105] added chapter 4 (§1471–§1474) to the Internal Revenue Code of 1986, which is often referred to as the Foreign Account Tax Compliance Act (FATCA). FATCA made sweeping changes to the U.S. withholding rules applicable to both "fixed or determinable annual or periodical" (FDAP) income realized by foreign persons and to sales of U.S. stocks and debt obligations by foreign persons. These changes are intended to ensure that U.S. citizens and residents are not able to skirt federal income tax on investment income by receiving that income through foreign financial accounts and certain non-financial foreign entities.

Under §1471–§1474, if a "foreign financial institution" (FFI) or a "non-financial foreign entity" (NFFE) receives certain U.S. source income and does not comply with the requirements to identify U.S. account holders or direct or indirect U.S. owners, then all items of FDAP income that are paid to the FFI or to the NFFE (if the NFFE is the beneficial owner) are subject to 30% U.S. withholding tax. Although gross proceeds from the sale of U.S. stocks and bonds were set to also become subject to 30% gross withholding in 2019,[106] Treasury and the IRS issued proposed regulations which eliminate the withholding requirement on such gross proceeds.[107] The FATCA rules do not change the *substantive* tax liability of foreign persons under §871 and §881, but are only *withholding* rules that are intended to ensure that U.S. investors do not use offshore accounts or entities to evade paying U.S. tax.[108]

Although the principal purpose of the FATCA provisions is to prevent U.S. persons from using foreign financial accounts and foreign entities (such as foreign corporations, foreign partnerships, and foreign trusts) to improperly reduce U.S. income tax on their *investment income,* the FATCA withholding rules apply to any "withholdable payment," which is defined broadly and generally includes any payment of "salaries, wages, … compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, *if such payment is from sources within the United States* … ."[109] This language is taken directly from §1441, which imposes 30% withholding tax on the same items of U.S.-source income realized by a nonresident alien individual. However, the term withholdable payment does not include a payment that is effectively connected with a U.S. trade or business,[110] which would generally be the case for compensation paid to a nonresident alien for services rendered in the United States.

Note, however, that the FATCA withholding rules do not apply to direct payments to *individuals,* but only to FFIs (§1471) and to NFFEs (§1472). Thus, the FATCA withholding rules do not apply to payments made to the three categories of self-employed individuals discussed in this Portfolio, i.e., U.S. citizens, resident aliens, and nonresident aliens.[111]

For a detailed discussion of FATCA, *see* 6565 T.M., *FATCA — Information Reporting and Withholding Under Chapter 4.*

[105] Hiring Incentives to Restore Employment (HIRE) Act, Pub. L. No. 111-147.

[106] §1473(1)(A)(ii); Reg. §1.1473-1(a)(1).

[107] Prop. Reg. §1.1473-1(a)(1); REG-132881-17, 83 Fed. Reg. 64,757 (Dec. 18, 2018).

[108] Thus, if a foreign investor is subject to the 30% tax on an item of FDAP income that is subject to lower U.S. tax either under the Code or under a tax treaty, the investor may file a federal income tax return (on Form 1040NR or Form 1120F, as the case may be) at year-end and claim a refund for the amount of any overwithholding. (However, if the beneficial owner of the payment is an FFI, the FFI is only entitled to treaty reductions and not Code reductions, e.g., the portfolio interest exemption. *See* §1474(b)(2)).

[109] §1473(1)(A). (emphasis added.) Section 1473 includes gross proceeds from the sale of U.S. stock and bonds in the definition of a withholdable payment. However, as discussed above, there is currently no withholding requirement on such payments. *See* Prop. Reg. §1.1473-1(a); REG-132881-17, 83 Fed. Reg. 64,757 (Dec. 18, 2018). *See also* Reg. §1.1473-1(a)(1)(ii).

[110] §1473(1)(B).

[111] It is generally assumed in this Portfolio that compensation for services paid in connection with a service provider's self-employment are paid personally to the individual, and not to an entity in which the individual owns an equity interest. *See* IX.I., below, for a brief discussion of the situation where U.S.-source service fees are paid to a foreign partnership or a foreign corporation whose partners and/or employees rendered services within the United States on behalf of the foreign partnership or corporation, and the potential applicability of the FATCA withholding rules in that context are considered.



ISBN 978-1-61746-986-2

## IV. U.S. Citizens and Resident Aliens Working in the United States as Employees

In general, under the "territorial rule," all wages for services performed in the United States are subject to U.S. income tax withholding.

### *A. Services Performed in the United States*

Where a U.S. citizen or resident alien is working in the United States as an employee, his or her wages are subject to wage withholding tax, unless a special exception applies in the Code or the regulations.

One such exception is when a U.S. citizen works for a foreign government or for an international organization. Those rules are discussed in more detail in connection with nonresident aliens working in the United States, in V.B.3., below.

In addition, there are two situations in which a resident alien employee may be exempt from U.S. tax by reason of an income tax treaty.

The first situation arises when the individual is a resident alien under the Code but as a resident of a treaty country under the "tie-breaker" language in the relevant tax treaty. The relevant treaty rules on employment income will frequently exempt such an individual from U.S. tax not only on all foreign-source employment income (as discussed above), but often on employment income for days spent on business trips into the United States. To be exempt from U.S. tax on salary for U.S. workdays, however, under most treaties his or her employer would have to be a foreign company, and certain other tests would have to be met.[112] This situation usually arises in the case of a individual who remained classified as a resident in his or her home country and who maintained his or her "permanent" home there. Claiming nonresident alien status under the §7701(b) regulations should not raise any problems under the U.S. immigration laws, because an individual who files as a nonresident alien for U.S. tax purposes would not necessarily be violating any U.S. immigration laws. For purposes of claiming the exemption, the same rules that apply to nonresident aliens who perform services in the United States but who are exempt from U.S. tax by Code or treaty would apply, as discussed further in V.B., below. Thus, the treaty tie-breaker resident of the treaty partner would complete Form 8233 for his or her employer in order to claim the exemption from U.S. tax.

The second situation applies to individuals who meet certain treaty requirements for teachers, students, researchers, trainees, and foreign government employees.[113] The relevant treaties provide for broad federal income tax exemptions in the case of such individuals who are classified as resident aliens for federal income tax purposes (and not reclassified as nonresident aliens under the tie-breaker provisions of a treaty), but who meet two additional tests:

(1) they were residents of the treaty country immediately before moving to the United States; and

(2) they do not have immigration status under the U.S. immigration laws (i.e., they hold non-immigrant visas).

This exemption may be available even if the individual is living in the United States. The applicable tax treaty should always be carefully examined to determine whether an exemption is available. Claiming the treaty exemption in this situation would not entail filing a nonresident alien tax return, but simply filing a resident alien tax return without showing the treaty-exempted income. In the case of students, teachers, researchers, and trainees who qualify for the treaty exemption, IRS Publication 519 states that the employee should file Form W-9 with his or her employer.[114] Because Form W-9 is not normally used to claim an exemption from wage withholding tax, however, the employee should attach a statement explaining the treaty exemption.[115]

### *B. Short-Term Work Outside the United States*

As discussed in section VI., below, there are a number of situations in which a U.S. citizen or resident alien is exempt from wage withholding tax on wages allocable to services performed outside the United States. As a general rule, however, those exceptions apply most often where the citizen or resident alien is based outside the United States. If a U.S. citizen or resident alien based in the United States travels outside the United States to work — whether to a foreign country, a U.S. possession or territory, or to a location not under the sovereign jurisdiction of a foreign country (such as the continent of Antarctica or the high seas) — there is usually no exemption from withholding tax for wages allocable to those workdays.[116] This will usually be true whether the employer is a U.S. company, or a foreign employer that may have no U.S. contacts apart from the fact that the particular individual's employment is based in the United States. This result seems appropriate, however, because the imposition of wage withholding tax will usually mirror the fact that substantive tax is imposed on the employee under §1 on the foreign-source portion of his or her salary as well as on the U.S.-source portion. This rule is to be contrasted, however, with the strict territorial rule that applies for FICA purposes where a U.S. citizen or resident alien makes business trips or undertakes a short-term work assignment outside the United States as the employee of an employer who is neither an "American employer" nor the "foreign affiliate" of an American employer.[117]

---

[112] *See*, e.g., Article 14 of the U.S. Model Income Tax Convention.

[113] *See* the detailed discussion of this issue in 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

[114] IRS Publication 519, *U.S. Tax Guide for Aliens.*

[115] *See* 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers,* recommending this procedure.

[116] As discussed further in VI., below, this is because the principal wage withholding exceptions for citizens and resident aliens working outside the United States are where their foreign-source salary is subject to foreign wage withholding tax, is expected to be excluded from gross income under §911, or is subject to foreign income taxes that will reduce or eliminate U.S. tax thereon under the foreign tax credit rules.

[117] *See* 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*



ISBN 978-1-61746-986-2

## V. Nonresident Aliens Working in the United States as Employees

### *A. Territorial Rule Applicable to Nonresident Aliens*

As indicated in II.D., above, the §3401 regulations provide that remuneration for services performed outside the United States by a nonresident alien individual is exempt from tax, while in most cases remuneration for work done within the United States is taxable.[118] Thus, the wage withholding rules and the rules on substantive personal income tax liability of a nonresident alien are based almost entirely on the place where employment services are rendered. The place where payment is received by the employee is not relevant, and the place where the employer is resident or does business is only rarely relevant.

Although salary paid to a nonresident alien employee for work done within the United States is generally subject to both wage withholding tax and substantive tax liability, several important exceptions, described below, are nevertheless available for certain categories of nonresident aliens who work in the United States.

In applying the "territorial" rule of §3401(a) with respect to nonresident aliens working within the United States, the possible application of the "included/excluded" rule of §3402(e) (discussed in II.C.6., above) should be considered. If a nonresident alien fails the de minimis test of §861(a)(3) for the year but spends less than half of his or her business time for a particular pay period within to the United States, all remuneration for such pay period would appear exempt from wage withholding under a literal reading of §3402(e). If this literal interpretation is correct, however, the U.S.-source portion of the employee's remuneration would probably be subject to 30% gross withholding under Reg. §1.1441-4(b)(1)(ii).[119]

If a nonresident alien employee whose employment is based in the United States works briefly outside the United States, on the basis of the regulations it is technically improper to withhold tax from salary allocable to the non-U.S. business days. If the nonresident alien's salary is covered by a U.S. payroll system, however, as a practical matter it is extremely unusual for a payroll system to "track" his or her U.S. and non-U.S. business days for any pay period. In most cases, therefore, his or her employer's payroll department would withhold wage withholding tax on all of the individual's salary, and he or she would then claim a refund for the overwithheld tax when he or she filed his or her tax return on Form 1040-NR, after the end of the year.[120] If the percentage of non-U.S. business time can be predicted with approximation in advance, however, an employer might arrange to withhold tax only on a percentage of salary that is expected to represent the U.S.-source portion of the employee's salary. As part of this process, the employer and employee might then meet towards the end of the year and go over the employee's business schedule for the prior months and "true up" the wage withholding for the year by arranging for either lesser withholding or more withholding in December.

### *B. Services Performed in the United States — Exempt Remuneration*

Pursuant to §3401(a)(6), Reg. §31.3401(a)(6)-1 provides for exemption in the case of services performed outside the United States by a nonresident alien, as well as exemption for services performed within the United States in certain categories:

(1) Canadian and Mexican residents working as employees in the transportation industry and on certain international boundary projects; and

(2) all nonresident aliens whose remuneration is exempt from tax under the Code or under an income tax treaty.[121]

Special rules apply to nonresident aliens who reside in Puerto Rico.[122] It should be noted that if a nonresident alien employee's remuneration for services in the United States is not exempt under these regulations, it may nevertheless be exempt from wage withholding tax in whole or in part under the other exemptions to the definition of wages in §3401(a). For example, a nonresident alien employed as a domestic servant in a private home or as an ordained minister would usually be exempt from wage withholding tax because a U.S. citizen or resident alien employee would also be exempt from wage withholding tax.[123]

Four other exemptions are worth noting:

(1) the "de minimis" exception available to certain short-term business visitors in §861(a)(3);

(2) the exemption for nonresident aliens holding F-, J- and Q-visas and employed by a foreign employer, under §872(b)(3);

(3) the §893 exemption for non-U.S. citizens employed by a foreign government or an international organization; and

(4) the exemption under §861(a)(3) for nonresident alien crew members on vessels engaged in international transportation.

Substantially broader exemptions are often available under an income tax treaty.

---

[118] Reg. §31.3401(a)(6)-1(b). *See also* Rev. Rul. 92-106.

[119] The reason is because the exemption from wage withholding would be under §3402(e) rather than §3401(a). Reg. §1.1441-4(b)(1)(vi) provides that if U.S.-source compensation of a nonresident alien is exempt from wage withholding under §3402(e), it is also exempt from 30% withholding under §1441, provided that the employer and employee enter into a "voluntary" wage withholding agreement with respect to the portion of compensation that is excluded from wage withholding under §3402(e). However, these regulations apparently contemplate that the portion of compensation that is exempt from wage withholding under §3402(e) is nevertheless subject to federal income tax under §1 in the hands of the nonresident alien employee — such as compensation received by a household servant in a private home, which is exempt from wage withholding under §3402(a)(3) but nevertheless taxed to the nonresident alien employee under §871(b). For the employer and employee to enter into a voluntary wage withholding agreement with respect to the foreign-source portion of a nonresident alien's compensation would make no sense because that portion of his or her compensation is exempt from federal income tax in the hands of the employee.

[120] Assuming that the nonresident alien employee's Form W-2 shows both his or her U.S.-source and foreign-source salary, the employee would need to attach an explanation to his or her tax return explaining why he or she was reporting an amount of wages on his or her tax return that was less than the amount shown as gross wages on the Form W-2.

[121] Reg. §31.3401(a)(6)-1(b), §31.3401(a)(6)-1(c), §31.3401(a)(6)-1(f).

[122] Reg. §31.3401(a)(6)-1(b), §31.3401(a)(6)-1(d).

[123] *See* §3401(a)(3), §3401(a)(9).



ISBN 978-1-61746-986-2

Apart from the question of whether a particular alien's compensation is exempt from wage withholding is the question of what documentation (if any) must be provided by the employee to the employer, and what documentation (if any) must be filed by the employer with the IRS. Whether the exemption is available under the Code, the regulations, or an income tax treaty, the regulations are unfortunately incomplete and in places contradictory. Because the relevant IRS forms and their instructions cover most situations, however, it is probably advisable for an employer and employee to rely on those sources rather than the Treasury regulations.

*1. De Minimis Exception*

Section 861(a)(3) and §864(b)(1) exempt a nonresident alien employee from federal income tax on compensation for services performed in the United States if three tests are met:

(i) the nonresident alien is temporarily present in the United States for a period or periods not exceeding 90 days during the taxable year;

(ii) his or her compensation for services performed in the United States does not exceed $3,000 in the aggregate; and

(iii) the compensation is for services as an employee of a foreign person not engaged in trade or business in the United States, or as the employee of an office maintained outside the United States by a U.S. person.

If a nonresident alien employee fails to meet any of these tests, then the employee is fully subject to tax on such compensation, and the compensation is also classified as "wages" on which the employer must withhold. These requirements of §861(a)(3) and §864(b)(1) are discussed in some detail in TAM 201014051, concerning the U.S. services of nonresident alien flight attendants working for foreign offices of a U.S. carrier.

As discussed further in V.B.6., below, nonresident alien employees who are resident in a tax treaty country will frequently qualify for exemption from federal income tax on compensation for U.S. services if their employer is resident in their home country (and under some treaties, if the employer is simply any foreign person). Because the exemption from U.S. tax under most treaties is available if the employee is present in the United States for not more than 183 days and there is usually no dollar limitation on the amount of compensation that can be received tax-free, the exemption in §861(a)(3) is of principal benefit to nonresident alien employees from non-treaty countries.

One may rightfully wonder how often nonresident alien individuals whose employer does not establish a formal branch office in the United States actually comply with the applicable tax filing and payment rules if they fail any of the three tests above. For example, a well-compensated foreign business executive who visited the United States on business for only a few days a year from a non-treaty country would probably fail the $3,000 test. It is doubtful that many such individuals pay the federal tax that is due or that their employers establish a formal payroll withholding system to comply with the withholding requirements of §3401 and §3402. Indeed, in many cases both the employee and the employer may be totally unaware of their U.S. tax payment and withholding obligations.

Serious problems of interpretation are also posed by the requirement in §861(a)(3)(C)(i) that the employer, if a foreign person, must not be engaged in trade or business within the United States. Although the case law is sparse on the circumstances which may cause a foreign person to be engaged in trade or business in the United States, the IRS on occasion has taken the position that where the income generated by a foreign company from the activities of its employees in the United States consists of service fees, the foreign company by definition is engaged in trade or business in the United States by reason of the presence of its employees.[124] Where those activities consist of business negotiations for contracts for the sale or purchase of goods, there will also be a strong possibility that the foreign employer will be engaged in a U.S. trade or business. However, the presence of employees who negotiate the purchase, sale or lease of investment property, such as real estate, in many cases would not give rise to a U.S. trade or business.[125]

If the employer is a U.S. person (other than the foreign office of a U.S. person), then the nonresident alien's compensation would fail the third test and would be subject to both U.S. tax liability and wage withholding tax. In such a situation, however, it is quite likely that the employer would have a payroll system in place and would withhold on all of the employee's compensation for services performed within the United States. An added complication in this situation, however, is that if the individual holds a B-visa under the U.S. immigration laws, it would be a violation of the U.S. immigration laws for him or her to be employed by the U.S. office of a U.S. employer; in addition, a B-visa alien would not be permitted to obtain a U.S. social security number, and as a result it would be extremely difficult to include the individual in a U.S. payroll system.[126]

Reg. §31.3401(a)(6)-1(f) provides that in the case of remuneration paid for services performed within the United States by a nonresident alien employee, which is exempt from federal income tax under the Code or by treaty, the employer and employee must comply with the §1441 regulations, specifically with the procedures in Reg. §1.1441-1(e)(1)(ii). Those regulations seem to require the nonresident alien to provide the employer with either Form W-8BEN or Form 8233, both of which are used by nonresident aliens to certify their foreign status and also in many cases to claim reductions in or exemptions from the 30% U.S. withholding tax under §1441. However, the instructions to both of those forms make clear that they may not be used by a nonresident alien who claims an exemption from withholding on compensation received as an employee which he or she claims is exempt under the *Code*, rather than under an income tax treaty.[127] Instead, the instructions provide that the employee should use Form W-4.

---

[124] Rev. Rul. 78-234 (language in ruling which holds that Tanzanian gross withholding tax on service fees paid to nonresidents of Tanzania is not creditable, because in the reverse situation a Tanzanian resident performing services in the United States would be taxable on a net basis under U.S. law). Rev. Rul. 78-234 was declared obsolete by Rev. Rul. 84-172.

[125] Rev. Rul. 73-522; *Neill v. Commissioner*, 46 B.T.A. 197 (1942).

[126] *See* the detailed discussion of this issue in 6830 T.M, *International Aspects of U.S. Social Security and Unemployment Taxes.*

[127] If the nonresident alien employee claims an exemption from withholding under an income tax treaty, he or she is clearly required to use Form 8233, but that form may not be used if the exemption is only claimed under a provision of the Code itself.



ISBN 978-1-61746-986-2

Form W-4 on its face does not easily lend itself to use by a nonresident alien who claims a blanket exemption from wage withholding under the Code, although it can probably be adapted for this purpose. The instructions to Form W-4 for nonresident aliens (which are contained in the instructions to Form 8233) do not mention this issue, and they expressly state that the nonresident alien should not claim the §3402(n) exemption from withholding on line 7. Because the IRS now requires a nonresident alien employee to write "Nonresident Alien" on line 6, however, an employer who receives Form W-4 from a nonresident alien will at least be on notice that special rules may apply to that particular employee. Because the employee in this situation would be claiming a blanket exemption from wage withholding tax under the Code, he or she should probably attach a pro forma statement to the form explaining his or her situation.

Although Form W-4 appears to be the correct form for a nonresident alien employee to give to his or her employer in claiming the §861(a)(3) exemption, the employee will not be eligible to receive a social security number, and thus no social security number can be shown on the Form W-4 because the employee's visit to the United States is likely to be on a short-term nonimmigrant visitor's visa (e.g., a B-1 visa). Realistically, compliance with the U.S. rules — whatever they really are — is probably extremely low on the part of most foreign employers whose nonresident alien employees visit the United States for periods that are brief enough to qualify for the §861(a)(3) exemption. In view of the probably hundreds of thousands of visitors to the United States each year from nontreaty countries who work during at least part of the time during their visit, it is almost impossible for the IRS to enforce these rules and to find out whether the visitors' documentation on file with their foreign employers is in compliance with the U.S. wage withholding tax regulations. Even if the IRS did attempt to monitor this area and to collect wage withholding tax from the indivdual' foreign employers, there is the obvious "Catch 22" situation of how the employer should comply with the U.S. rules when the employee is usually not permitted to obtain a U.S. social security number, as well as the obvious compliance issue of how the IRS could collect the tax from foreign employers who are not engaged in a U.S. trade or business.

If the IRS were to audit a foreign employer whose nonresident alien employees did in fact qualify for the §861(a)(3) exemption but which had not complied with any of the IRS documentation requirements, the question arises as to whether tax, interest, and/or penalties could be imposed on the foreign employer. As discussed in IX., below, in the case of the potential interest and penalties that can be imposed under the §1441 regulations in the case of nonresident aliens who are self-employed, there is a question whether tax, interest, and/or penalties may be imposed on the foreign employer if it can be proved that the §861(a)(3) exemption did in fact apply to the particular employee but that the employer did not comply with the IRS documentation requirements. It would appear that this very harsh rule in the §1441 regulations should not be applied in an employer-employee situation, because the regulations state that the imposition of tax, interest, and penalties is imposed for tax that is otherwise imposed under *chapter 3* of the Code — i.e., under §1441 itself.[128] If the §861(a)(3) exemption is available to the employee, therefore, the fact that timely documentation was not provided by the employee to the employer should not matter.

A related question is whether the employer is required to file any documentation with the IRS with respect to the employee's U.S. business visits, assuming, in the case of employees working remotely, the employer even knows the details of such visits. The §1461 regulations require Forms 1042 and 1042S to be filed in most situations where items of U.S.-source income are exempt from §1441 withholding. However, §861(a)(3) classifies a nonresident alien's compensation in this situation as foreign-source income. Thus, it would seem reasonable to take the position that no year-end reporting needs to be done under §1441 by the employer. It is possible (as discussed further below) that the employer may technically be required to furnish the employee with Form W-2 at year-end, but the alien employee's compensation would probably be excluded from the Form W-2 as foreign-source; in any event, it seems extremely unlikely that the IRS would attempt to enforce the $50 penalty under §6674 for failure to furnish Form W-2 to an employee.

A technical argument can be made that if a nonresident alien employee does satisfy the three-pronged test of §861(a)(3), his or her compensation is classified as foreign-source income by §861(a)(3), and thus his or her services were not performed "within the United States" within the meaning of Reg. §31.3401(a)(6)-1(f). This would mean that the apparent requirement (as discussed above) that the employee must give Form W-4 to his or her foreign employer would not apply. However, §861(a)(3) itself does not actually say that an employee who meets the three-pronged §861(a)(3) test will not be deemed to have performed services within the United States, but only that the remuneration for services performed in the United States will be deemed to be foreign-source income. As suggested above, however, in practice it is likely that the IRS treats short-term business visitors who satisfy the three-pronged test as if they are not in fact required to furnish any documentation to their foreign employer.

*2. F-Visa, J-Visa, and Q-Visa Holders*

Section 872(b)(3) provides for a federal income tax exemption for compensation paid to a nonresident alien employee holding an F-visa, J-visa, or Q-visa (student, State Department-approved exchange visitor, or cultural exchange representatives), by a "foreign employer" — a term which is defined as an employer that is either a non-U.S. person or a foreign office of a U.S. person. In contrast with the §861(a)(3) "de minimis" exception, the §872(b)(3) exemption is available even if the employer is a foreign person who is engaged in a trade or business in the United States, and apparently even if the employee's compensation is actually paid by a U.S. branch of the foreign employer and is deducted by the employer for U.S. corporate income tax purposes on Form 1120F. In addition, unlike

[128] This means that the provision in Reg. §31.3401(a)(6)-1(f), to the effect that an employer may rely on an employee's claim that it is entitled to a wage withholding exemption under the Code if the employee's claim complies with the requirements of the §1441 regulations, merely incorporates the §1441 procedures by reference into §3401. Accordingly, the various penalty provisions of the §1441 regulations should not apply. Furthermore, as noted in the text, the reference in the §3401(a)(6) regulations over to the §1441 regulations is not followed in the instructions to the various IRS forms.



ISBN 978-1-61746-986-2

the §861(a)(3) exemption — which reclassifies a nonresident alien's compensation as foreign-source income — §872(b)(3) does not reclassify the source of the employee's compensation (which remains U.S.-source income), but instead provides for an exclusion from gross income.

The rules in §7701(b)(5)(E) should always be consulted to determine whether the F-, J-, or Q-visa employee is a nonresident alien for the year.[129] An F-visa holder will usually be classified as a nonresident alien for his or her first five years in the United States. An alien holding a J- or Q-visa may be classified as a nonresident alien for his or her first four calendar years in the United States, where all of his or her compensation is paid by a qualifying foreign employer.

As with the §861(a)(3) wage withholding exemption, the question arises as to what documentation must be furnished by the §872(b)(3) employee to his or her employer, and what documentation the employer must provide to the employee and to the IRS. The same regulations and IRS forms discussed above with respect to §861(a)(3) also apply for §872(b)(3) purposes. Thus, the instructions to Forms W-8BEN and 8233 require in effect that the employee must claim the §872(b)(3) exemption on Form W-4.

It is much more likely that the §872(b)(3) employee will be in a U.S. payroll system and that he or she will have a social security number, because he or she will hold a valid U.S. work visa. Accordingly, it should be feasible for the §872(b)(3) employee to give the employer Form W-4, although it is not clear what if anything should be attached to the form in order to claim the §872(b)(3) exemption from wage withholding. Because the employer will often have assisted the employee in obtaining his or her U.S. nonimmigrant visa, the employer will usually want to help the employee to complete whatever IRS forms are required.

As discussed above, Reg. §1.1441-1(b)(7) provides that if the payor of U.S.-source income that is subject to the §1441 requirements does not obtain timely documentation from the payee in order to justify the failure to withhold U.S. tax on the payment, the tax plus interest and penalties may be imposed on the payor until such time as proper documentation is obtained.[130] Also as noted above, this rule apparently applies only if the document required from the payee is either in the Form W-8 series, or Form 8233, but not if it is Form W-4. Nevertheless, because a §872(b)(3) alien will have a valid U.S. work visa and social security number and will be able to provide Form W-4 to his or her employer, the employer should be advised to obtain timely and proper Forms W-4 from those employees, because of the remote possibility that the IRS might attempt to incorporate the §1441 tax-interest-penalty rule into the §3401 regulations by reference.[131] This should protect the employer from a subsequent claim from the IRS that it is liable for the tax that it should have withheld (plus interest and penalties) because it failed to obtain the required Form W-4 documentation to justify it in not withholding.

The question also arises whether the foreign employer is required to file any documentation with the IRS on Form W-2 or Forms 1042 and 1042S, and to provide copies thereof to the employee. The §1461 regulations require that U.S.-source "compensation for dependent personal services" must be reported on Forms 1042 and 1042S even if the compensation is excluded from gross income under the Code.[132] However, the same regulations also provide that "any item required to be reported on a Form W-2" need not be reported on Forms 1042 and 1042S.[133] Because of the extremely broad language of §6051(a), which mandates the Form W-2 procedures for employers, a strong argument can be made that the excluded §872(b)(3) compensation should in fact be reported on Forms W-2 and W-3 and not on Forms 1042 and 1042S. Section 6051(a) requires that "every employer engaged in a trade or business who pays remuneration for services performed by an employee … shall furnish to each such employee in respect of the remuneration paid by such person to such employee during the calendar year …." This language is repeated in the instructions to Form W-2, which also require that all "amounts you pay your employee from which Federal income tax is not withheld" must be reported in box 1, including presumably amounts that are excluded from gross income in the hands of the employee.

Because the employer will usually have a U.S. payroll system and will be issuing Forms W-2 to other employees whose compensation is subject to wage withholding, the employer should be able to provide Forms W-2 to nonresident alien employees whose compensation is excluded under §872(b)(3). In any event, the only civil penalty for failing to do so would appear to be the $50 penalty under §6674. If instead the employer is required to file Forms 1042 and 1042S and fails to do so, the civil penalties for nonfiling also appear to be fairly nominal — provided of course that it owes no withholding tax because it has obtained timely and proper Forms W-4.[134]

### *3. Employees of Foreign Governments and International Organizations*

#### *a. Direct Employees*

Employees of foreign governments and international organizations are another category of nonresident alien employees who are exempt from federal income tax One possible exemption is under §893. In order for the §893 exemption to be available, however, the services performed by the employee must be "of a character similar to those performed by" U.S. government employees in foreign countries, if the employer is a foreign government.[135]

The regulations under §3401(a)(5) provide a broader exemption, excluding from the definition of "wages" remuneration paid by a foreign government or international organization to a U.S. citizen or resident alien. Although §3401(a)(5) refers only to "a citizen or resident of the United States," the

[129] *See* 6400 T.M, *U.S. Income Taxation of Nonresident Alien Individuals.*

[130] Reg. §1.1441-1(b)(7), discussed in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting.*

[131] As noted above, Reg. §31.3401(a)(6)-1(f) provides that an employee who claims an exemption from wage withholding by reason of an exemption in the Code itself must comply with the procedures in Reg. §1.1441-1(e)(1)(ii).

[132] Reg. §1.1461-1(c)(2)(i)(E).

[133] Reg. §1.1461-1(c)(2)(ii)(D).

[134] Reg. §1.1461-1(h) provides that failure to file Forms 1042 and 1042S can result in the imposition of civil penalties under §6651, §6662, §6663, §6721, §6722, and §6723, as applicable.

[135] §893(a)(2).



ISBN 978-1-61746-986-2

regulations cover nonresident alien employees of such employers as well. Thus, Reg. §31.3401(a)(5)-1(a)(2) provides that "the citizenship or residence of the employee" is "immaterial" for employees of a foreign government, and that such remuneration is exempt from wage withholding tax in the case of all employees. Similarly, Reg. §31.3401(a)(5)-1(b)(1) provides that the exemption for employees of an international organization is available not only to U.S. citizens and resident aliens, "but also an employee who is a nonresident alien individual." Thus, while the regulations under §3401(a)(5) go beyond the language of §3401(a)(5) itself, the IRS has broad authority under §3401(a)(6) to extend that exemption to nonresident alien employees who may fail the literal requirements of the §893 exemption because of the specific nature of the work that they perform for their employer.

If remuneration paid to a nonresident alien employee is exempt from wage withholding tax under the broad language of the §3401(a)(5) regulations, no IRS form (for example, Form W-4, Form W-8BEN, Form W-9, or Form 8233) is required to be furnished by the employee to the foreign government or international organization. Presumably the absence of any documentation requirement is in recognition of the fact that if the regulations did require the foreign government or international organization to comply with the U.S. wage withholding tax regulations, any such requirements might be in violation of an agreement or international law. Nor is there any requirement that the foreign government or international organization file any returns or forms with the IRS or provide any IRS forms to the employee (for example, Forms W-2 and W-3, or Forms 1042 and 1042S).

*b. Employees of Corporations Owned by Foreign Governments*

Section 893 provides that the exemption from tax on salary received from a foreign government does not apply to:

(1) employees of a §892(a)(2)(B) "controlled commercial entity"; or

(2) employees of a foreign government whose services are primarily connected with a commercial activity of the foreign government (whether within or outside the United States).

As a result of this more restrictive rule, nonresident aliens who work within the United States as employees of a U.S. or foreign corporation that is wholly owned by a foreign government may be subject to wage withholding.

Section 3401(a) and the regulations have not been updated to address the availability of the foreign government employee exemption to employees of U.S. or foreign corporations that are wholly owned by a foreign government — except for a statement in the §3401(a)(5) regulations that the withholding exemption thereunder does not confer an exemption per se on employees of a U.S. corporation that is wholly owned by a foreign government (thus, the regulations deny the wage withholding exemption even if the U.S. corporation is engaged in governmental functions and not commercial activities).[136]

[136] Reg. §31.3401(a)(5)-1(a).

*4. Canadian and Mexican Residents*

The regulations under §3401(a)(6) provide a broad wage withholding tax exemption to nonresident aliens who are residents of Canada or Mexico, and who are engaged in either "transportation service," or "service on international projects."[137]

"Transportation service" is defined to include services performed as an employee in "railroad, bus, truck, ferry, steamboat, aircraft, or other transportation services," where the employee enters and leaves the United States at "frequent intervals."[138] The exemption is available whether the individual is an employee of a U.S. person or a foreign person.

Service on "international projects" is defined to include the "construction, maintenance, or operation" of a "waterway, viaduct, dam, or bridge" on either the U.S.-Canada or the U.S.-Mexico border. Again, the employee must enter and leave the United States at "frequent intervals" in order for these rules to apply.[139]

The regulations specify further that the wage withholding exception is not available if the employee works "wholly within the United States as, for example, where such a resident is employed to perform service at a fixed point or points in the United States, such as a factory, store, office, or designated area or areas within the United States, and who commutes from his home in Canada or Mexico, in the pursuit of his employment within the United States."[140]

In order for the wage withholding exemption to be available, the regulations require that the employee furnish the employer with a statement with his or her name, address and taxpayer identification number (if any) certifying that:

(1) he or she is not a U.S. citizen or resident alien;

(2) he or she is a resident of Canada or Mexico; and

(3) he or she expects to meet either the "transportation service" or the "international project" rules.

The regulations also provide that the statement must be filed with the IRS by the employer as an attachment to Form 1042-S. This requirement would appear to be outdated, now that the §1441 regulations have replaced similar employee statements with official IRS forms (including Forms W-4, W-8, W-9, and 8233). Thus, in situations where the employee's U.S.-source compensation is not exempt from U.S. tax under the U.S.-Canada or U.S.-Mexico Income Tax Treaty (as discussed immediately below), it may be more appropriate for the employee instead to give the employer a Form W-4 with a statement attached to it claiming the exemption from U.S. wage withholding tax on the basis of the §3401(a)(6) regulations. Because there generally is no exemption under the Code for nonresident aliens working on "international projects" or engaged in international transportation, the employer would be required to provide the employee and the IRS with Form W-2 after the end of the year. If the Canadian or Mexican resident has a substantive U.S. tax liability, he or she would usually be required

[137] Reg. §31.3401(a)(6)-1(c).
[138] Reg. §31.3401(a)(6)-1(c)(1).
[139] Reg. §31.3401(a)(6)-1(c)(2).
[140] Reg. §31.3401(a)(6)-1(c)(3).



ISBN 978-1-61746-986-2

to make estimated tax payments as well as to report his or her remuneration for U.S. services on a U.S. tax return (Form 1040-NR) for the year.

In many situations, of course, the Canadian or Mexican employee might be exempt from substantive U.S. income tax liability under the "dependent personal services" article of the U.S.-Mexico Income Tax Treaty[141] or the "income from employment" article of the U.S.-Canada Income Tax Treaty.[142] If that is the case, the employee and the employer would comply with the treaty procedures mandated by the §1441 regulations (discussed in V.B.6., below) instead of the §3401(a)(6) regulations. Both treaties contain a rule exempting from U.S. tax compensation realized by the Canadian or Mexican resident for services performed in the United States if:

(1) the individual is not present in the United States for more than 183 days in the year;

(2) the employer is not a U.S. resident; and

(3) the employee's compensation is not borne by a U.S. permanent establishment of the employer.[143]

The U.S.-Canada treaty is broader, however, because it also provides two additional exemptions. If the employer is a U.S. resident, the Canadian employee's compensation is exempt from U.S. tax if it does not exceed U.S. $10,000 for the year.[144] In addition, if the employer is a Canadian resident and the Canadian employee works "on a ship, aircraft, motor vehicle or train" operated by the employer, the employee's compensation is exempt from U.S. tax even if he or she is in the United States for more than 183 days in the year.[145]

*5. Crew Members of Foreign Vessels*

Under §861(a)(3), compensation for services performed in the United States by a nonresident alien crew member of a foreign vessel is treated as foreign-source income if:

(i) the employee's services are performed in connection with the crew member's temporary presence in the United States as a regular member of the foreign vessel crew, and if

(ii) the foreign vessel is engaged in transportation between the United States and a foreign country or a possession of the United States.

Section 7701(b)(7)(D) treats qualifying nonresident alien crew members as not present in the United States for purposes of §7701(b) on days when they are present temporarily in the United States as a crew member of a foreign vessel.

Based on the discussion in V.B.1., above, regarding short-term visitors whose compensation may also be classified as foreign-source income, it is likely that these same rules apply to crew members of a foreign vessel whose compensation for work done in the United States is also classified as foreign-source. Thus, technically the crew member may be required to file Form W-4 with the employer, and the employer may technically be required to file documentation with the IRS (Forms W-2 and W-3, or possibly Forms 1042 and 1042S as an alternative).

These rules do not apply to nonresident aliens who work as part of the crew of a foreign *aircraft.* Although most income tax treaties contain a broad exemption from U.S. income tax (and therefore from U.S. wage withholding tax) for compensation realized by an alien resident in the treaty country from an airline that is resident in the same country (or, under some treaties, an airline that is resident in the United States and/or in a third country), no similar exemption is available under the Code for employees of airlines from non-treaty countries — even if the airline itself is exempt from U.S. income tax under the "reciprocal exemption" rules of §872(b)(2) and §883(a)(2). Those nonresident alien employees are subject to tax, and thus subject to U.S. wage withholding, on the portion of their compensation that is U.S.-source income. Under a special 50-50 allocation rule in §863(c)(2)(A), the employee's U.S.-source income would include not only income from services performed while physically within the United States, but also income attributable to a portion of the time traveling between the United States and a foreign country.

*6. Remuneration Exempt Under an Income Tax Treaty*

The regulations under §3401(a)(6) also provide for an exemption from wage withholding tax in the case of remuneration for services performed in the United States that is exempt from federal income tax under an income tax treaty.[146] With respect to compensation that is exempt from U.S. tax by treaty, the regulations make applicable procedures that govern treaty exemptions of self-employed nonresident aliens under Reg. §1.1441-4(b)(2). It is clear under those rules that the nonresident alien must file Form 8233 with the employer, and this is confirmed by the instructions to Form 8233. Under the Form 8233 rules after 2000, moreover, the Form 8233 must include an "individual tax identification number" (ITIN).[147]

In contrast with the limited personal income tax exemptions available to nonresident alien employees under the Code,[148] broader exemptions are available to employees resident in tax treaty countries with respect to remuneration for services performed in the United States. Thus, compared to the de minimis rule of §861(a)(3), most treaties exempt from tax remuneration for services performed in the United States if certain additional tests are met. In most treaties an employee who is present in the United States for not more than 183 days is exempt from U.S. tax, without a dollar limitation, provided that:

(i) the employer is resident in the treaty country (a rule which is expanded in many treaties to include any foreign employer, and sometimes an office maintained in the treaty country of a U.S. employer), and

(ii) the remuneration is not borne by a permanent establishment in the United States of the employer.

[141] U.S.-Mexico Tax Treaty, Article 15.

[142] U.S.-Canada Income Tax Treaty, Article XV.

[143] U.S.-Canada Income Tax Treaty, Article XV.2(b); U.S.-Mexico Tax Treaty, Article 15.2.

[144] U.S.-Canada Income Tax Treaty, Article XV.2(a).

[145] U.S.-Canada Income Tax Treaty, Article XV.3.

[146] Reg. §31.3401(a)(6)-1(f).

[147] Reg. §1.1441-4(b)(2)(ii)(A). If the individual has not yet received an ITIN, he or she can attach a copy of a completed Form W-7 or SS-5 showing that a number has been applied for.

[148] *See* V.B.1. through V.B.5., above.



ISBN 978-1-61746-986-2

Most treaties also provide for broad exemptions for certain categories of employees, such as shipping and aircraft workers, foreign government employees, teachers, students, researchers, trainees, and business apprentices.

Because of the United States' income tax treaty network, many nonresident aliens qualify for treaty exemptions from U.S. tax each year with respect to services performed within the United States. These include not just short-term foreign business visitors on temporary B-1 visas or entitled to visa waivers but also individuals who spend time in the United States for personal reasons but continue to perform services for their employer. It is difficult to imagine that more than a small percentage of these individuals will take the time and trouble to apply for an ITIN[149] and complete Form 8233, or that their foreign employers will submit Form 8233 to the IRS in accordance with the applicable procedures whenever an employee visits the United States on business. Given the number of employees and the difficulty in contacting them, the ability of the IRS to enforce these rules broadly is doubtful.

Still, the IRS could seek to impose tax plus interest and penalties on a foreign employer who does not obtain timely Forms 8233 from its treaty-country-resident employees who conduct business during visits to the United States. Reg. §1.1441-1(b)(7) imposes tax plus interest and penalties on the payor of U.S.-source income who does not obtain a timely Form 8233 from the foreign payee, even if the payment is clearly exempt from U.S. tax and thus would clearly be exempt from U.S. withholding tax if timely documentation were received. These rules clearly apply in the case of payments of U.S.-source compensation to nonresident aliens who are *self-employed*, but it is not clear from the §3401(a)(6) and §1441 regulations whether they also apply to nonresident alien *employees* who are supposed to follow the §1441 procedures in claiming a wage withholding exemption under Reg. §31.3401(a)(6)-1(f).

The practical effect of such a rule would be to deny the benefits of the treaty exemption unless the employee and the employer complied with the extremely burdensome, and presumably costly, Forms W-7 and 8233 procedures. If the IRS attempted to enforce such a rule, it would clearly cause havoc in the international business community. To date the IRS has never formally announced that it intends to apply Reg. §1.1441-1(b)(7) to nonresident alien employees, but the possibility that the IRS might someday make such an announcement and attempt to selectively enforce this rule cannot be excluded.

Apart from short-term visitors to the United States, another category of nonresident alien employees working in the United States are required to file Form 8233 to report tax treaty exemptions. Nonresident alien teachers, students, trainees, and business apprentices who are entitled to treaty exemptions from U.S. tax on part or all of their salary for working in the United States are required to file Form 8233.[150] Because they hold valid U.S. work visas (and thus U.S. social security numbers) and because their compensation is usually paid through a U.S. payroll system, presumably most of their employers comply with these rules.

Presumably W-2/W-3 reporting is done by an employer whose nonresident employees are in a U.S. payroll system (i.e., teachers, students, trainees, and business apprentices).[151] An argument can be made on the basis of the regulations in favor of either reporting on Form 1042/1042S reporting or Form W-2/W-3 reporting in the case of short-term visitors who are treaty-exempt. Compliance in this area is likely poor, however, and that the potential civil penalties for not filing the proper forms — apart from the risk that the Reg. §1.1441-1(b)(7) tax-interest-penalty rule could apply — are nominal.

### C. *Services Performed in the United States — Taxable Remuneration*

To the extent that remuneration paid to a nonresident alien employee for work done in the United States is subject to wage withholding tax, the general rules described in II., above, are applied. Thus, the employee's remuneration for work done in the United States is taxable and withholding must be implemented in accordance with the withholding method selected by the employer. This means that the special rules applicable to nonresident alien employees must be used, as discussed immediately below.

In *Guo v. Commissioner*,[152] in a case of first impression, the Tax Court considered the question of whether unemployment benefits paid to a nonresident alien were subject to U.S. tax or were exempt from tax under the applicable income tax treaty. The taxpayer was a Canadian citizen who worked for the University of Cincinnati as a post-doctoral fellow for one year then applied for and received unemployment compensation from the Ohio Department of Job and Family Services (department) following her return to Canada. No tax was withheld from the payments and the department filed a Form 1099-G. The taxpayer timely filed a Form 1040-NR-EZ[153] reporting the income and claiming the payments were tax exempt under Article XV, then titled "Dependent Personal Services," of the U.S.-Canada Income Tax Treaty. The IRS assessed, taxpayer petitioned the Tax Court, and argued alternatively, if Article XV did not apply, the payments were tax exempt under Article XXII, "Other Income," of the treaty. The parties having agreed the income was U.S. source and effectively connected, the only issue before the court was the treaty issue.

The Tax Court first reviewed the rules of treaty interpretation and looked to the plain meaning of the text,[154] the intent of the parties in entering into the agreement,[155] and general-

[149] The ITIN rules require in part that the individual must submit to the IRS (or to a duly authorized "acceptance agent") specified original or certified documents proving identity, foreign status and residency. *See* §6109(i), added to the Code by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §203; Notice 2016-48.

[150] Rev. Proc. 2005-44, *obsoleting* Rev. Proc. 87-8, *modified by* Rev. Proc. 93-22, and Rev. Proc. 87-9, *modified by* Rev. Proc. 93-22, and Rev. Proc. 93-22A, provides that the procedures described in IRS Pub. 519, *U.S. Tax Guide for Aliens*, for students, teachers, trainees, and business apprentices should be followed instead.

[151] *See* the discussion in V.B.2., above, with respect to nonresident aliens working in the United States who qualify for the §872(b)(3) exemption.

[152] 149 T.C. 334 (2017).

[153] Since 2020, redesigned Form 1040-NR is used in place of 1040-NR-EZ.

[154] 149 T.C. 334, 337 (2017) (citing *Volkswagenwerk Aktiengesellschaft v. Schlunk*, 486 U.S. 694 (1988); *Sanchez-Llamas v. Oregon*, 548 U.S. 331 (2006)).

[155] 149 T.C. 334, 337 (2017) (citing *United States v. Stuart*, 489 U.S. 353 (1989)).



ISBN 978-1-61746-986-2

ly more liberal construction than private agreements.[156] Neither the treaty nor its protocols specify how unemployment compensation should be treated, so the court turned to Article XV itself, which, by its terms, governs the treatment of "salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment." The court determined that unemployment compensation is not salaries or wages and turned to the definition of the term "remuneration," also not defined in the treaty or its protocols, or in the Code. The court then turned to the Code for where else the term remuneration was used. Section 3401(a) defines wages as "all remuneration" for services performed by an employee for his employer (including benefits), and then lists 23 types of remuneration that are excepted from the definition of wages. Section 3121(a) also uses the term remuneration in its definition of wages for employment to include the cash value of all remuneration (including benefits) paid in any medium other than cash. Based on these uses of the term, the court determined unemployment compensation does not constitute "similar remuneration derived … in respect of an employment" within the meaning of Article XV of the treaty.[157] The court then noted that even if the unemployment compensation benefits were covered under Article XV of the treaty, Article XV did not help the taxpayer because it granted the state of residence taxing jurisdiction unless the services were provided in the other state and in the taxpayer's case, the unemployment compensation was paid in respect of employment that took place in the United States, therefore, the unemployment compensation would still be taxable in the United States under Article XV. In addition, the two exceptions to the general rule of Article XV(1) were not applicable under the taxpayer's facts. The taxpayer then argued in the alternative, if Article XV did not apply, the unemployment compensation payments were "other income" under Article XXII of the treaty and therefore not subject to U.S. taxation. The court characterized Article XXII as a "catchall provision that covers items of income not dealt with elsewhere in the treaty." Article XXII provides generally that the state of residence has taxing jurisdiction over "other income," but that the source country may also tax such amounts. The court concluded therefore the United States could tax the unemployment compensation payments under Article XXII. The taxpayer argued that she would be subject to double taxation if the United States asserted source country jurisdiction over the unemployment compensation and subjecting her to double taxation would be in contravention of Article XXIV, "Elimination of Double Taxation," under the treaty, to which the court responded that her remedy was with Canada, not with the United States.

### 1. *Special Form W-4 Rules for Nonresident Alien Employees*

Special wage withholding rules apply to employees who are classified as nonresident aliens. Under §3402(f)(6), a nonresident alien employee may claim only one withholding allowance. Section 31.3402(f)(6)-1(a)(2), however, provides that this single withholding allowance is the deduction allowed to the nonresident alien individual under §151. Accordingly, a nonresident alien employee may not claim any withholding exemptions for taxable years 2018 through 2025[158] and may claim one withholding exemption after 2025, unless he or she qualifies as a resident of Canada, Mexico, or Puerto Rico, and has eligible dependents.[159]

In addition, Article 4(7) of the U.S.-Korea Income Tax Treaty allows, subject to certain limitations, a Korean resident who is not a resident of the United States to claim personal exemptions for certain eligible dependents, subject to the conditions prescribed in §151–§153 "as in effect on the date of the signature of this Convention." The Convention was signed on June 4, 1976, entered into force on October 20, 1979, was in force on December 22, 2017 when Pub. L. No. 115-97 was signed into law, and remains in force to this day. Pub. L. No. 115-97 makes no mention of overriding the U.S.-Korea Income Tax Treaty, therefore this provision in the treaty remains the governing law with respect to Korean residents temporarily resident in the United States who are qualified for benefits under the U.S.-Korea Income Tax Treaty.[160] This rule permits a qualified Korean resident to claim additional withholding allowances on Form W-4 with respect to those qualified dependents.[161] A nonresident alien employee who is treated as a resident alien by reason of an election under §6013(g) or §6013(h) may also claim more than one withholding exemption.[162] It is not clear whether or not Treasury and the IRS will extend this latter rule to "withholding allowances" in light of the definition of exemption amount as zero for taxable years beginning after 2017 and before 2026.

The rule in §873(b)(3) limiting nonresident alien employees to one personal exemption can result in significant overwithholding in many cases where the employee is entitled to

[156] 149 T.C. 334, 377 (2017) (citing *Air Fr. v. Saks*, 470 U.S. 392 (1985)).

[157] 149 T.C. 334, 338–339 (2017). *Cf.* §3402(o)(1)(A) (providing that a supplemental unemployment compensation benefit received from an employer will be treated "as if it were payment of wages by an employer to an employee for a payroll period" and will be subject to wage withholding); *United States v. Quality Stores, Inc.*, 572 U.S. 141 (2014) (finding severance payments made by an employer to an employee to be "supplemental unemployment compensation benefits" under §3402(o)).

[158] Treasury and the IRS have concluded that the withholding exemption referenced in §3402(f)(6) is the deduction allowed to the nonresident alien individual under §151. *See* Reg. §31.3402(f)(6)-1 finalized by T.D. 9924, 85 Fed. Reg. 63,019 (Oct. 6, 2020), applicable on and after October 6, 2020. *See Personal Exemption Tables* in Federal Tax Tables, Charts & Lists for personal exemption amounts in recent years under §151.

[159] Although §3402(f)(6) remains unchanged by the Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, significant portions of §3402(f) were modified by the TCJA to reflect the addition of §151(d)(5) by TCJA, §11041(a), which provides that for taxable years beginning after 2017 and before 2026, the term "exemption amount" means zero, effectively suspending the personal exemption for taxable years 2018 through 2025. The TCJA amended the heading of §3402(f) from "Withholding Exemptions" to "Withholding Allowances" and in most subsections of §3402 replaced the word "exemption" with "allowance," including subsections §3402(f)(3), §3402(f)(4), §3402(f)(5), and §3402(f)(7); it did not make the amendment to §3402(f)(6). Section 3402(f)(1) and §3402(f)(2) were amended to reflect the suspension of personal exemptions and the move to allowances as a measure for withholding. For taxable years beginning before 2018, *see* §873(b); former Reg. §31.3402(f)(6)-1 before amendment by T.D. 9924, 85 Fed. Reg. 63,019 (Oct. 6, 2020). With respect to the exceptions for aliens resident in Mexico, Canada, and Puerto Rico, §3402(f)(6) does not allow any exceptions to the rule of one personal exemption, but Reg. §31.3402(f)(6)-1 allows withholding allowances to be claimed by aliens resident in Mexico, Canada, and Puerto Rico for personal exemptions that may be claimed by the individual under §873(b)(3) or §876. *See* CCA 201027046.

[160] *See* §894, §7872(d).

[161] *See* IRS Pub. 519, *U.S. Tax Guide for Aliens* and Instructions to Form 8233 (section entitled "Completing Form W-4").

[162] Reg. §31.3402(f)(6)-1.



ISBN 978-1-61746-986-2

claim large "effectively connected" deductions.[163] The rationale for such a limitation is that nonresident aliens are often subject to U.S. tax jurisdiction only for short periods of time, and if a W-4 were filed claiming excessive withholding exemptions, the IRS might not be able to collect the resulting tax deficiency from the nonresident alien. In order to avoid this possibility, the IRS may collect the deficiency from the employer if the employer had reason to know that the alien was a nonresident alien and if it improperly withheld on the basis of a Form W-4 provided by the employee. In any event, the overwithholding that occurs would be refunded to the alien following the filing of a return after year-end.

Notwithstanding the fact that overwithholding on a nonresident alien (especially on nonresident alien employees in states that impose an income tax) may occur, the IRS has been more concerned about the possibility that *underwithholding* on a nonresident alien employee may occur in those situations where the employee will claim little or no deductions against his or her effectively connected income. The IRS concern is based on the fact that the standard deduction — which is not allowed to any nonresident alien other than certain individuals from India (as discussed below) — is partially built into the wage withholding tables. As a result, unless some adjustment were made to the nonresident alien employee's wage withholding, the amount of tax that would be withheld for the year would reflect the allowance of one personal exemption as well as a portion of the standard deduction. Unless the employee's allowable itemized deductions on his or her tax return equaled or exceeded the portion of the standard deduction that is reflected in the withholding tables, therefore, underwithholding would occur.

The IRS initially attempted to correct this problem in 2005 by requesting all nonresident alien employees to request their employers to withhold an additional amount in each pay period in order to compensate for the disallowed portion of the standard deduction. The procedure that the IRS required, however, resulted in overwithholding for those employees earning less than the personal exemption amount for 2005. Accordingly, in Notice 2005-76,[164] the IRS changed this procedure and instead directed employers (beginning January 1, 2006) to calculate the wage withholding during each pay period by adding to the alien employee's annual wages an amount equal to the portion of the 2006 standard deduction that is reflected in the percentage method withholding tables for single individuals, *i.e.*, $2,650.[165] Because the 2006 wage withholding tables exempted $2,650 of annual wages from withholding, in addition to the $3,300 personal exemption amount, no overwithholding would result on nonresident alien employees earning $3,300 or less for the year.[166] In the case of nonresident alien employees with allowable deductions for the year under §873(b) in addition to the $3,300 personal exemption, however, the procedure in Notice 2005-76 simply exacerbates any overwithholding that was already occurring when the standard deduction was still allowed to be reflected in the alien's withholding tax. As noted above, however, the rule permitting only one withholding allowance (other than the zero allowance status between 2018 through 2025) to be claimed by a nonresident alien employee is clear in §3402(f)(6), and the procedures in the Notice are only attempting to carry out the statutory mandate as accurately as possible.

The instructions for nonresident alien employees on how to complete Form W-4 are not contained on Form W-4 itself, but are contained in the instructions to Form 8233.[167] Those instructions direct the nonresident alien employee to:

(1) not claim exemption from wage withholding;

(2) request withholding on the basis of single status (even if he or she is married);

(3) claim only one withholding allowance (except for certain residents of Canada, Mexico, or the Republic of Korea); and

(4) write "Nonresident Alien" or "NRA" on line 6.

This is intended to alert the employer to add back the standard deduction for calculation purposes.

Employees from Canada, Mexico, Korea, and Puerto Rico who are entitled to claim personal exemptions for eligible dependents may do so on Form W-4. In addition, because the U.S.-India Income Tax Treaty permits students and business apprentices from India to claim the standard deduction,[168] those individuals are not required to ask their employer to add back the standard deduction to their wages for calculation purposes. The Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, increased the standard deduction by adding §63(c)(7), which provides that for taxable years beginning after December 31, 2017 and before January 1, 2026, the basic standard deduction is $18,000 in the case of a head of household, or $24,000 in the case of a joint return or a surviving spouse, or $12,000 in any other case.[169] Section 63(c)(7) also provides an inflation adjustment applicable to the new standard deduction applicable for this period of time.[170] This increased standard deduction is in-

[163] *See Personal Exemption Tables* in Federal Tax Tables, Charts & Lists for personal exemption amounts in recent years under §151.

[164] Notice 2005-76, *modified by* Notice 2009-91. Notice 2009-91 modified Notice 2005-76 to change the withholding rules applicable to nonresident alien employees to offset the effect of the Making Work Pay Tax Credit under §36A, as well as the standard deduction, effective with respect to wages paid on or after January 1, 2010. However, as the credit expired at the end of 2010, employers must apply the original rules as in effect under Notice 2005-76 for wages paid on or after January 1, 2011. *See* Notice 2011-12.

[165] Notice 2005-76 makes clear that the add-back of the standard deduction is for calculation purposes only, and must not be reported on the employee's Form W-2 at year-end as additional income.

[166] At the same time, the IRS also issued Notice 2005-77, which provides that a nonresident alien whose taxable wages for the year are less than the personal exemption amount need not file a federal tax return unless a return might be required for some other reason (for example, because the individual has non-effectively-connected income on which less than the applicable rate of tax was withheld under §1441).

[167] *See also* Notice 1392 for taxable year 2020 on how to complete Form W-4.

[168] U.S.-India Income Tax Treaty, art. 21(2). The standard deduction may not be claimed by any other nonresident aliens, either under the Code or under any other U.S. income tax treaty. Article 21(2) of the U.S.-India Income Tax Treaty has also been interpreted by the IRS as permitting Indian students and business apprentices to claim dependency deductions under §151 for dependents who otherwise qualify under §151 (certain dependent U.S. citizens, resident aliens, and residents of Canada and Mexico). *See* Rev. Proc. 93-20 for a detailed discussion of the IRS interpretation of Article 21(2) of the U.S.-India Income Tax Treaty.

[169] Pub. L. No. 115-97, §11021(a).

[170] For standard deduction amounts in recent years under §63, *see Standard Deduction Tables by Year* in Federal Tax Tables, Charts & Lists.



ISBN 978-1-61746-986-2

tended to compensate for the limitations put on individual deductions and reduction of personal exemption amount to zero.

Although the wage withholding regulations contain special rules for nonresident aliens — primarily the "only one withholding exemption" rule (or zero for 2018–2025, as discussed above) — they contain little guidance on how an employer is expected to know whether an employee is a nonresident alien or a resident alien, particularly during the employee's first year in the United States. Because the issue does not often arise in the course of an IRS payroll audit, the issue is probably for the employee, who may have a personal preference as to whether he or she may be underwithheld or overwithheld for the year. An important issue for an individual who anticipates making a §7701(b)(4) resident alien election for the year is that the applicable IRS regulations require generally that the alien's tax for the year must initially be paid in on a nonresident alien basis, with a claim for refund of the overpayment resulting from the resident alien election to be claimed when the alien ultimately files his or her return for the year.[171]

Thus, in practice, the burden of claiming resident or nonresident alien status for wage withholding purposes is generally placed on the employee, unless the employer has knowledge that the employee's status is different from the status he or she claims. (This might occur, for example, if the alien employee has a J-visa and is clearly classified as a nonresident alien under §7701(b)(5) by reason of his or her visa status.) If the employee considers himself or herself to be a nonresident alien, he or she would furnish Form W-4 to the employer and claim single status (whether or not he or she is married), and in general only one withholding allowance; in accordance with the IRS rules in Notice 2005-76, he or she would also write "Nonresident Alien" on line 6.[172] In addition, if he or she makes foreign business trips, he or she may wish to discuss how to reflect the non-taxability of the allocable salary in the employer's wage withholding system. If the employee considers himself or herself to be a resident alien, then he or she would file Form W-4 in the same manner as a U.S. citizen, although certain variations could apply. (For example, if he or she is a resident alien for only part of the year, he or she would be denied the standard deduction but permitted to claim itemized deductions, and in addition he or she would be denied the right to use the joint return tables unless he or she made a §6013(g) or §6013d(h) election.)

If an employee files Form W-4 with the employer claiming either resident alien or nonresident alien status and the IRS later determines during a payroll audit that the claimed status was wrong *and* that as a result underwithholding occurred, the question arises whether the employer could be held liable for the amount of the underwithholding. Curiously, there is nothing in the regulations or in the IRS publications for employers expressly stating that an employer is liable for *any* type of underwithholding that occurs as the result of incorrect information that the employee has put on his or her Form W-4. Thus, if the employer has either actual knowledge, or constructive knowledge ("reason to know"), that the employee's status as claimed on Form W-4 is wrong, there are no explicit penalties in the Code or the regulations on the employer for underwithholding.

In contrast, the §1441 regulations specifically require that the payor of an item of U.S.-source income must be able to "reliably associate" a pending payment with "valid documentation" of the payee's U.S. or foreign status. In this regard, the payor must have "no actual knowledge or reason to know that any of the information, certifications, or statements in, or associated with, the documentation are incorrect."[173] If the payor cannot "reliably associate" the payment with valid documentation and makes the payment with either no withholding or withholding at less than the statutory 30% rate, in most cases he or she is liable for the amount of withholding tax up to the 30% rate.[174]

Although §6682 imposes a $500 penalty on an employee who had "no reasonable basis" for a statement on Form W-4, there appear to be no civil penalties on an employer who knows, or has reason to know, that an employee's Form W-4 is wrong, and where underwithholding occurs as a result of the erroneous Form W-4. Despite this apparent rule, as a matter of sound business practice an employer's payroll department should have some involvement with this issue, especially if the employer has sponsored the U.S. nonimmigrant visa application of an alien employee who is temporarily on its payroll. It may be advisable for it to refer all such employees to IRS Publication 519, *U.S. Tax Guide for Aliens*, and it may want to follow established "default" status presumptions for certain categories of alien employees, and to ask those employees to explain why they believe they should be treated differently. For example, an employer may want to treat F- and J-visa employees presumptively as nonresident aliens, and it may want to treat other nonimmigrant aliens as presumptive nonresident aliens during their first calendar year in the United States and as resident aliens for subsequent years.[175]

Further, if the employer is a public company that is subject to the Sarbanes-Oxley legislation, moreover, the internal control requirements of §404 of Sarbanes-Oxley should always be considered.

### 2. *Withholding on U.S.-Source Remuneration Only if Classified as Wages*

Notwithstanding the restrictive wage withholding rules that may apply to nonresident alien employees under the special Form W-4 rules, a careful examination should be made of each element in the alien's compensation package to determine the extent to which each item is classified as wages subject to withholding. For example, certain employment-related benefits may not be classified as wages. In particular, nonresident alien employees whose "tax home" is in a foreign country may receive reimbursements of many of their temporary U.S. living expenses in the form of reimbursed employee business expenses, which are exempt from wage withholding tax

[171] Reg. §301.7701(b)-4(c)(3)(v)(A).

[172] *See* the discussion immediately above.

[173] Reg. §1.1441-1(b)(1), §1.1441-1(b)(2)(vii), discussed in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*.

[174] Reg. §1.1441-1(b)(7)(i).

[175] *See* the discussion in 6400 T.M, *U.S. Income Taxation of Nonresident Alien Individuals*, on the nonresident alien or resident alien classification of employees working temporarily in the United States.



ISBN 978-1-61746-986-2

under Reg. §31.3401(a)-1(b)(2) as "traveling and other expenses." This subject is discussed further in II.D.4., above.

*3. Services Performed Both Within and Without the United States*

As the result of the territorial rule of Reg. §31.3401(a)(6)-1(b), which exempts nonresident aliens from wage withholding tax for work done outside the United States, a nonresident alien who is taxable on remuneration for work inside the United States may wish to arrange with the employer to specially handle withholding tax for services performed while outside the United States. As discussed above, as a practical matter it may be difficult for the employer to arrange for the payroll system to track the employee's U.S. and foreign workdays. If however, the employee is highly compensated and spends significant business time outside the United States, he or she may wish to reduce the substantial overwithholding that would otherwise occur if withholding is based on his or her total salary for the year.

*4. Wage Withholding Is Almost Never at 30% Rate*

Section 1441 imposes a 30% withholding tax on certain items of U.S.-source income that are paid to nonresident alien individuals. It is important to note that the 30% rate under §1441 is almost never imposed on remuneration that is paid to a nonresident alien employee by the employer. Reg. §1.1441-4(b)(1)(i) and §1.1441-4(b)(1)(ii), pursuant to authority delegated by §1441(c)(4), expressly provides that withholding is not required under §1441 from "salaries, wages, remuneration" or other personal services compensation of a nonresident alien if either:

(1) such compensation is subject to withholding under §3402; or

(2) such compensation would be subject to withholding as remuneration paid to an employee, but for the fact that a special exception from the definition of "wages" is granted by §3401(a).

These rules have the effect of exempting most remuneration paid to a nonresident alien employee by the employer from 30% withholding under §1441.[176]

The IRS confirmed this result in Rev. Rul. 92-106, in which it ruled that wages paid to a nonresident alien for services performed in the United States were income that was effectively connected with a U.S. trade or business, and therefore (assuming the exception contained in §864(b)(1) did not apply), were subject to withholding under §3402(a). If a nonresident alien is classified as self-employed rather than as an employee, however, then his or her self-employment income for services performed within the United States may be subject to 30% withholding tax under §1441. This issue is discussed further in IX., below.

***D. Nonresident Aliens Electing Resident Status Under Section 6013(g) and (h)***

Section 6013(g) and §6013(h) permits certain categories of married individuals who are nonresident for either part or all of the year to elect to be treated as resident aliens for federal income tax purposes. Both provisions state expressly that an electing individual is treated as a resident alien for federal income tax purposes for the taxable year for which the election is made, and also for purposes of wage withholding under Internal Revenue Code chapter 24 "for payments of wages made during such taxable year."[177]

As discussed above, there are a number of distinctions made for wage withholding purposes between nonresident alien employees and resident alien employees. These include:

(1) the requirement that married nonresident aliens be classified as single under the withholding tables instead of married;

(2) the limited use of the Form W-4 by nonresident aliens; and

(3) the general territorial rule whereby nonresident aliens are exempt from wage withholding on remuneration for work done outside the United States, and often qualify for Code or treaty exemptions for work done within the United States.

Notwithstanding the distinctions between nonresident and resident alien status for wage withholding purposes, a significant practical question arises concerning the first taxable year for which a §6013(g) or §6013(h) election is effective. Although the statute requires the individual be treated as a resident for such year, the election under both subsections is not actually made until the employee individual files his or her tax return for the year (although in the case of the §6013(g) election, the effect of the election continues into subsequent taxable years so as to classify a nonresident alien as a resident alien in those years, provided that certain tests are met).[178] Neither the §6013 regulations nor the wage withholding regulations indicate to what extent an employer should treat a nonresident alien employee as a resident alien under §6013(g) or §6013(h) prior to the time he or she makes the election, or what kind of notification can or should be given by the employee to the employer at any particular point in time.

*Comment:* The statute contemplates that the alien's elective resident alien status for the year is to be effective for wage withholding purposes. Presumably Congress contemplated that sometime during the taxable year the employee could give notification to the employer of his or her intention to make the election and that the employer could rely on that notification. Despite the silence in the regulations on this issue, presumably a nonresident alien who intends to make the election should be permitted to notify the employer in writing so as to reduce the overwithholding that would otherwise occur in many cases.

It should be noted that Reg. §31.3402(f)(6)-1 expressly permits a nonresident alien who elects resident alien status un-

[176] The only situation in which wages might technically be subject to 30% withholding tax under §1441 is where an exemption from wage withholding with respect to U.S.-source compensation is exempt under the "included/excluded" rule of §3402(e).

[177] §6013(g)(1)(B), §6013(h)(1). *See* 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals.*

[178] Reg. §1.6013-6(a)(4), §1.6013-7(a)(3).



ISBN 978-1-61746-986-2

der §6013(g) and/or §6013(h) to claim more than one withholding allowance. This provision suggests that an employee who expects to make a §6013(g) or §6013(h) election should be permitted to notify the employer in advance and to reflect the anticipated election in his or her wage withholding. However, the regulations under §3402(l)(3)(A), which require a married nonresident alien to use the single withholding tables, do not provide that such an alien may use the married tables.[179] Presumably there is sufficient authority in the language of §6013 itself, however, to permit the employee to use the married tables.

### *E. Resident Alien Election Under Section 7701(b)(4)*

Although the withholding allowance regulations under §3402(f)(6) expressly permit an individual who elects joint return status under §6013(g) or §6013(h) to claim more than one withholding allowance, those regulations do not state that a nonresident alien who expects to make a resident alien election under §7701(b)(4) may also claim more than one withholding allowance.[180] Because individuals who make the §7701(b)(4) election also often make a §6013(g) or §6013(h) election for the same year, however, those individuals presumably would be permitted to claim more than one withholding allowance in advance, and also to use the married tables instead of the single tables. Those individuals should be aware, however, that their §7701(b)(4) election could be invalid if their tax for the year is not calculated and paid in by April 15 of the following year on a nonresident alien basis. The §7701(b)(4) regulations require this to be done in order for the §7701(b)(4) election to be valid, even though a portion of the tax as calculated on a nonresident alien basis will subsequently be refunded to the individual pursuant to his or her resident alien election. The effectiveness of this requirement of the regulations is uncertain because it is not mentioned in §7701(b)(4) itself.

### *F. Estimated Tax Requirements*

If wage withholding on a nonresident alien employee's remuneration is less than the amount of his or her substantive tax liability for the year, as determined when he or she files his or her Form 1040-NR, the employee is technically required to make estimated tax payments to make up for the underwithholding. Form 1040-ES(NR) is used for this purpose. If the withholding tax regulations have been followed correctly, however, in many cases the nonresident alien employee will be overwithheld rather than underwithheld.

### *G. Foreign Employer Who Fails to Withhold*

Foreign employers commonly fail to withhold with respect to a nonresident alien employee working on a temporary basis within the United States whose compensation is partially or fully subject to wage withholding tax. This situation can arise in a number of contexts. An employee may visit the United States on short business trips or work remotely from the United States for a short period and fail the §861(a)(3) or relevant tax treaty exemption. Or, an employee may be transferred (or choose for personal reasons to work) for an indefinite period of time to the United States but kept on the foreign employer's payroll and not transferred to the U.S. payroll system of a U.S. branch or related U.S. subsidiary or parent company.

A typical reason for not withholding is the enormous practical difficulties that a foreign employer must face in establishing a formal U.S. payroll system. The employer must obtain an IRS employer identification number, and must make periodic deposits of tax and file Form 941 periodically. Moreover, if a payroll system is established to withhold pursuant to §3402, other payroll taxes must almost certainly be withheld or paid as well, including the Federal Insurance Contributions Act (FICA) tax (both employer's and employee's tax), the Federal Unemployment Tax Act (FUTA) tax, state unemployment tax and possibly state workmen's compensation insurance and disability tax, and possibly state and local wage withholding tax as well. Social security numbers or taxpayer identification numbers must be obtained for the nonresident alien employees involved. The foreign employer may also have well-founded corporate income tax reasons for not complying with its wage withholding and other payroll tax obligations. It may justifiably fear that the filing of Form 941 and the making of deposits of payroll taxes could lead to an IRS assertion that the employer is engaged in trade or business within the United States, and is thereby subject to corporate income tax on effectively connected income. The exposure to federal corporate income tax could also result in exposure to state income tax under the "doing business" tests of the states where nonresident alien employees may be located.

If the nonresident employee obtains a U.S. work visa that permits him or her to be an employee of a U.S. company, it should be possible to avoid the difficulties described immediately above by placing the employee on the payroll of a U.S. branch, subsidiary, or parent of the foreign employer. If the employee's services actually benefit the foreign employer rather than a related U.S. company that may be the employer of record, a "seconding" arrangement could be instituted whereby the U.S. employer charges the foreign employer for reimbursement of the salary and related payroll costs of the employee. In this situation, however, there may also be compelling reasons for keeping the employee on the payroll of the foreign employer instead of transferring him or her to the U.S. payroll of the related company. For example, the foreign employer may wish to keep the employee in its pension plan in the home country, and transferring him or her onto the payroll of a U.S. company may cause a lapse in coverage. Similarly, the employer may wish to keep the employee in the home country social security system so as to avoid a lapse in coverage that may occur if he or she is transferred to a U.S. payroll. It is to be noted that if the foreign employer has a U.S. branch office with a payroll system, placing the employee on the U.S. payroll would usually not result in a lapse in home country pension or social security coverage. However, such a lapse could occur if the U.S. payroll system is maintained by a separate U.S. corporation (*e.g.*, by a U.S. subsidiary or U.S. parent company of the foreign employer).

If a nonresident alien employee is on the payroll of a foreign employer who does not establish a U.S. payroll system, or if a related company maintains a payroll system but the foreign employer chooses not to place the employee on that pay-

[179] *See* Reg. §31.3402(l)-1(d)(1)(ii).

[180] *See Personal Exemption Tables* in Federal Tax Tables, Charts & Lists for personal exemption amounts in recent years under §151. For a discussion of the §7701(b)(4) resident alien election, *see* 6400 T.M, *U.S. Income Taxation of Nonresident Alien Individuals.*



ISBN 978-1-61746-986-2

roll through a "seconding" arrangement, the foreign employer will be exposed to liability for the tax plus interest and penalties, as discussed further in XIII., below. If the foreign employer chooses not to withhold as required by law, at the very least it should arrange for the employee to pay his or her U.S. income tax liability voluntarily in the form of estimated tax payments in order to make up for the absence of wage withholding. In that event, §3402(d) would relieve the foreign employer of liability for payment of the tax itself, although interest and penalties could still be imposed on it.

If an employee who works in the United States in this situation wishes to ensure that U.S. social security tax (FICA) is paid on his or her behalf, technically there is no way for the employee to pay FICA himself or herself. However, an *ad hoc* procedure appears to have developed whereby the employee may file IRS Form 4137 as an attachment to his or her federal income tax return, and pay the employee portion of FICA, to establish quarters of coverage for benefit purposes.[181] Form 4137 is generally supposed to be used by employees to report tip income that they have not reported to their employer.

It is sometimes contended that a foreign employer might be able to reduce wage withholding tax, as well as FICA and FUTA tax, by taking the position that a nonresident alien working for it within the United States is in fact a self-employed independent contractor or consultant. If the individual is in fact self-employed, then it is true that the employer would not be subject to these taxes, or to interest and penalties for non-payment of these taxes. Under the §1441 regulations, however, it is likely that the employer would nevertheless be liable for 30% withholding tax on U.S.-source self-employment income paid to nonresident aliens (plus interest and penalties for nonpayment of such tax), as discussed in VI.B., below. It is much more likely, however, that the alien will in fact be classified as an employee under the relevant IRS rulings and court decisions on the question, particularly if he or she is considered as an employee for purposes of coverage in the employer's home country pension plan, or for purposes of coverage under the social security tax laws of the home country.

### *H. Nonresident Aliens Without a U.S. Social Security Number*

The general territorial principle of the wage withholding tax rules means that a business visitor (B-1 visa) from a nontreaty country may be subject to wage withholding tax with respect to business trips into the United States, even though the employer may be a foreign company with no U.S. office. Even in the unlikely event that the B-1 visitor's foreign employer wishes to comply with its wage withholding tax obligations, it will probably be faced with a "Catch 22" situation, because although it may be clear under the Code that the B-1 visitor is subject to wage withholding tax, the Social Security Administration's regulations on the issuance of social security numbers will usually prohibit the issuance of a number to a B-1 visa holder. Although the nonresident alien would usually be permitted to apply for and obtain an Individual Taxpayer Identification Number (ITIN), an ITIN may not be used for federal employment tax purposes.

*Comment:* It is quite common for a non-U.S. citizen to move to the United States for a period of several years, but under circumstances in which the individual must wait several months after the move to obtain a work visa that permits him or her to work for a U.S. company and to obtain a Social Security number (e.g., an E-, H- or L-visa). Because such an individual typically holds a B-1 visa during the months that he or she is awaiting his or her new visa, he or she may not be paid salary by the U.S. company until he or she obtains his or her work visa, because:

(1) receiving a salary from a U.S. company would violate the terms of his or her B-visa; and

(2) unless he or she has a U.S. social security number from a prior U.S. employment, he or she will not be permitted to obtain a U.S. social security number until he or she has obtained the visa that permits him or her to work for a U.S. company.

In this situation, either the individual remains on his or her home country payroll until he or she obtains his or her new visa and his or her social security numbers — invariably without withholding of FICA and other U.S. payroll taxes by the foreign employer — or he or she is paid "advances" by the U.S. or foreign employer which are later "cancelled" in the form of a large taxable "bonus" from the U.S. company, with FICA and other U.S. payroll taxes paid thereon at that time. Of course, these concerns are magnified in the case of a nonresident who, by choice, spends time working "informally" in the United States for his or her employer.

### *I. Exceptions from Section 1441 Withholding*

The §1441 regulations contain a number of exceptions from the 30% withholding tax in the case of compensation for personal services of a nonresident alien individual.[182]

#### *1. Wages Subject to Section 3402 Withholding*

In order to avoid double withholding, the regulations provide an exemption in the case of wages which are subject to withholding under §3402.[183] In this regard, it should be stressed that pre-1967 revenue rulings on the subject of withholding on nonresident employees should be read with extreme caution. Prior to the amendment of the Code and the §1441 regulations in 1966, nonresident aliens working as employees within the United States were subject to withholding at the flat 30% rate imposed by §1441. In at least two pre-1967 rulings involving nonresident alien employees, therefore, the IRS ruled that 30% gross tax should be withheld from the employees' compensation.[184] Under the facts of both rulings, the present §1441 regulations would exempt such compensation from 30% withholding tax under §1441, and the compensation would instead be subject to the wage withholding rules of chapter 24 of the Code.

[181] However, Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, is used to figure and report the employee's share of the uncollected Social Security and Medicare taxes for employees who were mistreated as an independent contractor by their employer. *See* the discussion of this issue in 6830 T.M, *International Aspects of U.S. Social Security and Unemployment Taxes.*

[182] Reg. §1.1441-4(b)(1), §1.1441-4(b)(2).

[183] Reg. §1.1441-4(b)(1)(i).

[184] Rev. Rul. 64-184, Rev. Rul. 66-76.



ISBN 978-1-61746-986-2

*2. Remuneration Exempt from Section 3402 Withholding*

The §1441 regulations provide further that remuneration paid to a nonresident alien employee is also exempt from 30% withholding if it constitutes wages that *would be* subject to wage withholding under §3401(a) (other than the special nonresident alien wage withholding rules in §3401(a)(6)), but for a specific exception contained in §3401(a).[185] An example would be remuneration paid to a nonresident alien employee in an exempt industry, such as to a domestic household servant.

*3. Certain Wages Exempt from Withholding Under Section 3402(e)*

Reg. §1.1441-4(b)(1)(vi) contains a special rule that is designed to require withholding on some basis where the "included-excluded" rule of §3402(e) may provide an exemption from wage withholding tax. As discussed in II.C.6., above, if a nonresident alien employee works in the United States for less than one-half of the days in the employer's pay period, then an exemption from wage withholding may be available under §3402(e). As a result, the portion of the employee's compensation allocable to U.S. workdays will be subject to 30% withholding under §1441, because the exception for U.S.-source compensation subject to wage withholding will not apply. Reg. §1.1441-4(b)(1)(vi) provides in effect that 30% withholding tax can be exempted if the employer and employee enter into a "voluntary withholding" agreement under §3402(p), so that wage withholding at the graduated §3402 rates will be applied to the employee's salary. The effect of this rule is to avoid the overwithholding that could result for many employees if the flat 30% withholding rate is applied under the §1441 regulations. In practice, however, a §3402(p) agreement is likely to be limited to U.S. employers with nonresident alien employees who travel extensively outside the United States and who are based in the United States. It is unlikely that foreign-based employers will generally comply with these rules.

*4. Form 1042/1042S Filing Requirements*

The §1461 regulations require Form 1042 and Form 1042S to be filed after the end of the year to report payments which were potentially subject to §1441 withholding but which were exempt from withholding "because of a treaty or Internal Revenue Code exception to taxation."[186] The only exception in the regulations with respect to remuneration for services is for "any item required to be reported on a Form W-2."[187]

Under the regulations, therefore, amounts that are subject to mandatory wage withholding under §3401(a)(1) (discussed above) are clearly exempt from Form 1042/1042S reporting. As discussed in V.B., above, items of U.S.-source compensation that are exempt from wage withholding tax may technically be required to be reported on Form W-2; if that conclusion is correct, then no Form 1042/1042S reporting would be required with respect to U.S.-source compensation paid to a nonresident alien employee that is excluded from gross income under the Code.

Civil (and potentially criminal) penalties may be imposed for nonfiling or for late filing of Forms 1042/1042S.[188]

[185] Reg. §1.1441-4(b)(1)(ii).

[186] Reg. §1.1461-1(c)(2)(i).

[187] Reg. §1.1461-1(c)(2)(ii)(D).

[188] Reg. §1.1461-1(h) provides that failure to file Forms 1042 and 1042S can result in the imposition of civil penalties under §6651, §6662, §6663, §6721, §6722, and §6723, as applicable.



ISBN 978-1-61746-986-2

## VI. U.S. Citizens and Resident Aliens Working Outside the United States as Employees

### *A. U.S. Citizens*

U.S. citizens are subject to U.S. income tax on their worldwide income, and the territorial rule described in V.A., above, for nonresident aliens has no application. Nevertheless, certain variations of the territorial rule do apply, in that exclusions from gross income are allowed for certain categories of foreign-source income, and the tax on foreign-source income that is not excluded may often be reduced by foreign income taxes that have been imposed on that income.[189]

As with nonresident aliens working outside the United States, the wage withholding rules applicable to U.S. citizen employees working outside the United States attempt to track the rules on substantive liability. Thus, the general rule that U.S. citizens are subject to wage withholding on remuneration for services performed anywhere in the world is relaxed to the extent that the citizen may qualify for the exclusions under §911 for foreign-source earned income, under §931 for possessions-source and other foreign income, and under §933 for Puerto Rican-source income. Adjustment may also be made to reflect anticipated foreign tax credits. In addition, a wage withholding exemption is available where remuneration is subject to wage withholding under foreign law.

This section VI.A. of the Portfolio discusses the wage withholding exceptions available to U.S. citizens working outside the United States, as well as other special wage withholding questions faced by U.S. citizens working abroad.

#### *1. Income Excluded Under Section 911*

Remuneration payable to a U.S. citizen is exempt from wage withholding tax under §3401(a)(8)(A)(i), "if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excluded from gross income under section 911 … ." The regulations state that a "reasonable belief" may be based upon "any evidence reasonably sufficient to induce such belief," even though on closer examination it may not be sufficient to establish the §911 exclusion.[190]

The regulations state that an employer may presume that an employee will qualify for the §911 exclusion if the employee executes a statement that he or she expects to so qualify, in the form prescribed in Reg. §31.3401(a)(8)(A)-1(a)(2). This statement may be executed on Form 673, *Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911*.[191] The prescribed statements on Form 673 are in slightly different form for employees who expect to satisfy the 330 day "physical presence" test of §911(d)(1)(B), and those who expect to qualify as a "bona fide resident of a foreign country" under §911(d)(1)(A). In the case of an employee who completes the bona fide resident statement, after two years in which the statement is furnished to the employer, the employer may presume that the employee qualifies as a bona fide foreign resident without requesting similar statements in succeeding years.[192] The statement prescribed in the regulations may not be relied upon if the employer has reason to believe that it is improper. However, the employer is apparently not required to obtain Form 673 from an employee in order to stop withholding under this exception, because any other evidence that meets the test of the regulations may also be relied upon. For example, if the employer arranges the employee's compensation package and determines the number of days that he or she will be working outside the United States, presumably all information in the employer's personnel department relating to the employee's transfer abroad would be sufficient evidence for the employer to cease withholding under this exception, if it appeared from the circumstances that the §911 rules would be satisfied.

Where the U.S. citizen employee is expected to receive remuneration from the employer that is expected to be partially exempt under §911 and partially includible in the employee's gross income, Reg. §31.3401(a)(8)(A)-1(a)(1)(ii) provides that the remuneration that is paid to the employee is to be prorated to the §911 exclusion and to non-excluded income with respect to each payment.

> *Example:* In 2025, a U.S. citizen employee is paid remuneration of $260,600, all of which is for services performed outside the United States. Of this amount, $130,000[193] (exactly one-half) is excluded under §911, and the $130,000 excess is included in gross income. One-half of each monthly salary payment of $21,667, or $10,833 monthly, is exempt from wage withholding and the balance of $10,833 monthly is subject to wage withholding, unless otherwise excepted under §3401.

If part or all of an employee's compensation is excluded from wage withholding because the employee expects to claim the §911 exclusion, it is not clear from the Form W-2 instructions whether the amount that is excluded from wage withholding should be included in the amount of wages shown in box 1 on Form W-2. The prudent approach is that the amount should be included, because the employee might not qualify for the exclusion or, if he or she is eligible to claim it, may not elect to claim it when he or she eventually files his or her U.S. income tax return on Form 1040 for the year.

#### *2. Remuneration from Working in Certain U.S. Possessions*

Remuneration paid to a U.S. citizen employee for services within a U.S. possession (other than Puerto Rico) is exempt from wage withholding tax under §3401(a)(8)(B) if it is rea-

[189] *See* §901 (foreign tax credit rules), §164(a)(3) (deduction for foreign income taxes).

[190] Reg. §31.3401(a)(8)(A)-1(a). *See also* Rev. Rul. 92-106.

[191] For a discussion of exclusions from gross income under §911, *see* 6080 T.M, *Section 911 and Other International Tax Rules Relating to U.S. Citizens and Residents.*

[192] Reg. §31.3401(a)(8)(A)-1(a)(2)(ii).

[193] Under §911(b)(2)(D)(ii), as amended by §515 of the Tax Increase Prevention and Reconciliation Act of 2005 ("the Act"), Pub. L. No. 109-222, the dollar amount of the §911 exclusion was $82,400 for 2006 and is adjusted for inflation in subsequent years. For the inflation adjusted exclusion amounts in recent years, *see Foreign Earned Income Exclusion Tables by Year* in Federal Tax Tables, Charts & Lists. The Act also reduced the deductible "housing cost amount" under §911(c) for most individuals eligible to claim the §911 exclusion. For purposes of simplification, no deduction is claimed in this example for the housing cost amount.



ISBN 978-1-61746-986-2

sonable to believe that at least 80% of the remuneration will be for services performed within a U.S. possession. This rule is based on the pre-1986 rules of §931, which provided that the possessions exclusion was only available if the individual realized 80% of gross income from sources within the possession. As amended in 1986 and again in 2004, §931 does not contain a percentage requirement, and instead provides that any income from sources within a possession is excluded from gross income under the Code if the individual is a "resident" of that possession, as specially defined in §937.[194]

Thus, a practical approach would be for the employer to match U.S. wage withholding (if any) with the employee's §931 exclusion.[195] However, whether or not an employee's possessions-source remuneration is substantial enough to reach the 80% requirement of §3401(a)(8)(b), in most cases the remuneration will be subject to wage withholding under the possession's internal income tax law, and thus would be exempt from U.S. wage withholding under the (alternative) "foreign wage withholding tax" rule discussed in VI.A.4., below.

Because the U.S. Virgin Islands has an internal income tax system that is different from those of the other U.S. possessions, a "parallel" regulation in Reg. §31.3401(a)-1(b)(12) provides for an exemption from U.S. wage withholding if an employee is a resident of the U.S. Virgin Islands under §28(a) of the Revised Organic Act of the Virgin Islands.[196] The regulation requires that the employee provide a statement to the employer that he or she expects to be so classified, and that the employer must file a copy of such statement with the IRS. It is likely that this rule has been overridden by the enactment of §937 in 2004, which requires that individuals claiming residence in the U.S. Virgin Islands as well as in four other U.S. possessions satisfy certain uniform requirements in order to be classified as residents of the possession for U.S. tax purposes. In any event, even if a U.S. citizen is not classified as a Virgin Islands resident under either §937 or under §28 of the Revised Organic Act, and even if his or her remuneration for the year is not substantial enough to reach the 80% requirement of §3401(a)(8)(b), in most cases the remuneration will be subject to wage withholding under the Virgin Islands' internal income tax law, and thus would be exempt from U.S. wage withholding under the (alternative) "foreign wage withholding tax" rule, discussed in VI.A.4., below.

### 3. *Income Excluded Under Section 933*

Remuneration paid to a U.S. citizen employee for services performed within Puerto Rico is exempt from wage withholding tax under §3401(a)(8)(C) if it is reasonable to believe that the employee will be a bona fide resident of Puerto Rico during the entire calendar year for purposes of §937. In such a situation, the employee's Puerto Rico-source remuneration will be excluded from gross income under §933.[197] As noted above with respect to the other U.S. possessions, if a U.S. citizen performs services within Puerto Rico and is not a bona fide resident there (and thus his or her Puerto Rico-source remuneration is not eligible for the §933 exclusion), it is likely that the remuneration will be exempt from U.S. wage withholding tax under the foreign wage withholding tax rule discussed in VI.A.4., below.

### 4. *Remuneration Subject to Foreign Wage Withholding Tax*

Section 3401(a)(8)(A)(ii) provides for a wage withholding exemption for remuneration paid for services by a U.S. citizen employee in a foreign country or a U.S. possession if the employer is "required" by the law of any foreign country or U.S. possession (including Puerto Rico) to withhold income tax upon such remuneration.

Section 31.3401(a)(8)(A)-1(b) does not require the employee to give any documentation to the employer to substantiate this exception. Some advisors recommend that the employee give the employer a statement attached to his or her Form W-4 to the effect that he or she believes no U.S. wage withholding is required because the compensation is subject to foreign wage withholding tax. In any case, if the employer fails to withhold U.S. wage withholding tax because of an erroneous belief that an employee's salary is subject to foreign wage withholding tax, the fact that the employer has such a statement from its employee would probably not prevent interest and penalties (and possibly tax as well) from being imposed on it, because the responsibility of knowing the foreign wage withholding rules would have fallen on the employer and not the employee.

#### a. *Employer Must Be Legally Required to Withhold Under Foreign Law*

The regulations provide that this exemption is not available unless wage withholding tax is actually imposed under foreign law, and an employer agrees with the employee to satisfy the employee's estimated tax or final tax payments under foreign law.[198] For example, under the laws of many foreign countries, employees are required to pay personal income tax on wage and salaries on a voluntary self-assessed basis. Thus, the foreign wage withholding exemption of §3401(a)(8)(A)(ii) would not be available for U.S. citizens working in those countries.

#### b. *Foreign Political Subdivisions*

The regulations also contain a curious rule to the effect that the foreign wage withholding test is not met by reason of a withholding requirement under the laws of a "political subdi-

[194] *See* the discussion of §937 in 6400 T.M, *U.S. Income Taxation of Nonresident Aliens.*

[195] It should be noted that the §931 exclusion technically applies only to Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (CNMI), but because of special rules in §935 that apply to Guam and the CNMI, in practice the §931 exclusion may apply only to American Samoa. A different set of rules applies under §932 to the U.S. Virgin Islands. All of these rules are beyond the scope of this Portfolio. For further details, *see* 7390 T.M., *Business Operations in the Territories and Possessions of the United States (except Puerto Rico).*

[196] 68 Stat. 508 (1954); *see also* 48 U.S.C. §1541, et seq.

[197] For further details, *see* 7320 T.M, *Business Operations in Puerto Rico.*

[198] Reg. §31.3401(a)(8)(A)-1(b)(2) ("Mere agreements between the employer and the employee whereby the estimated income tax of a foreign country or of a possession of the United States is withheld from the remuneration in anticipation of actual liability under the law of such country or possession will not suffice."). *See also* CCA 200814010 (withholding exemption provided by §3401(a)(8)(A)(ii) is not available where foreign law does not require income tax withholding, regardless of whether employer enters into agreement with foreign country to replicate a tax withholding system).



ISBN 978-1-61746-986-2

vision of a foreign state."[199] While this rule may be technically correct under the literal language of §3401(a)(8)(A)(ii), which requires that there be wage withholding under "the law of any foreign country," it certainly does not conform with the foreign tax credit rule which interprets the term "income … taxes paid … to any foreign country" as including income taxes paid to the political subdivision of a foreign country.[200] This restriction would arise only where a wage withholding tax is imposed at the level of a political subdivision but not also at the national level.

*c. Rate of Foreign Withholding Tax Not Relevant*

An important feature of the §3401(a)(8)(A)(ii) exemption is that it is not necessary to show that the foreign wage withholding tax is imposed at levels comparable to U.S. wage withholding tax. Thus, foreign wage withholding tax imposed at an extremely low flat rate would be sufficient to exempt all of a U.S. citizen employee's foreign-source remuneration, subject to that country's withholding tax, from the U.S. withholding tax. Thus, in PLR 8129013, the IRS considered the question whether the employer's obligation to pay over the 5% Saudi Arabian Social Insurance Tax on employees' remuneration would exempt the employer from U.S. wage withholding under §3401(a)(8)(A)(ii). The IRS ruled on technical grounds that the employer was not legally required under Saudi law to withhold the employees' tax from the remuneration paid to them. As a result, the procedural rules of Saudi law were considered insufficient to qualify the employer for the §3401(a)(8)(A)(ii) exemption. However, the extremely low rate of Saudi tax was not considered grounds for the denial of a favorable ruling to the employer, nor was the fact that Saudi Arabia did not impose a more general income tax on employees. (Because the Saudi Social Insurance Tax was classified as a foreign income tax, it qualified as an "income tax" for purposes of §3401(a)(8)(A)(ii).)

*d. The Foreign Withholding Tax Must Be on "Income"*

To qualify for the foreign wage withholding exclusion, the foreign withholding tax must be imposed on an employee's income. However, this does not necessarily mean that the tax must be imposed under a general income tax that is imposed by the foreign country, so long as the foreign tax qualifies as an "income tax" that may be credited by the employee (if he or she elects the credit) under §901. Thus, in PLR 8129013, the IRS ruled that the Saudi Arabian Social Insurance Tax was an income tax for which the employee was eligible to claim a foreign tax credit, even though it was imposed under the social insurance laws of Saudi Arabia as a quasi-social security tax. This conclusion conforms with a number of IRS rulings which hold that a foreign social security tax imposed on an employee's salary are foreign income taxes that may be credited under §901.[201]

These rulings, however, preceded amendments to the regulations under §901 that narrowed the definition of an "income tax" for purposes of §901. The IRS has not provided guidance as to whether this narrower definition of "income tax" carries over to §3401(a)(8)(A)(ii).[202] If a foreign social security tax or similar social insurance tax does qualify as an income tax under §901, the further question arises whether that particular tax qualifies as a foreign wage withholding tax for purposes of §3401(a)(8)(A)(ii) if the social security tax is imposed by a country with which the United States has a social security "totalization agreement," and which for that reason may not be claimed as a credit under §901.[203] This issue can be important for U.S. citizens working in totalization countries such as France that do not have wage withholding under the income tax laws, but which do impose wage withholding under their social security laws. Although it is clear that the employee's social security tax paid to a totalization country may not be claimed as a foreign tax credit under §901, the federal law disallowing the §901 credit does not provide that the foreign country's social security tax will not be classified as an income tax for other purposes of the Code. Based on the discussion of the Saudi Arabian social insurance tax, therefore, it would seem that if mandatory withholding is imposed under the social security laws of a totalization country on an employee's salary, that procedure should exempt the employee's salary from U.S. wage withholding tax under §3401(a)(8)(A)(ii).

*e. Relationship to the Section 911 Exclusion*

Where remuneration for work outside the United States is expected to be excluded under §911 and is also subject to foreign wage withholding tax, Reg. §31.3401(a)(8)(A)-1(a)(1)(ii) suggests that the exemption for foreign wage withholding tax be applied on that portion of the salary that is not considered to be excluded under §911. This interpretation seems to be confirmed by the ruling in Rev. Rul. 92-106. Thus, it is necessary in each pay period to determine that portion (if any) of salary for work done outside the United States that is not excluded under §911. To the extent that the non-excluded salary is subject to foreign wage withholding tax for the pay period, §3401(a)(8)(A)(ii) would exempt such salary from U.S. wage withholding tax.

*f. Peculiarities of Foreign Law*

To the extent that the §911 exclusion rule of §3401(a)(8)(A)(i) is not available and no other U.S. wage withholding exemption is available, the foreign wage withholding exemption of §3401(a)(8)(A)(ii) should be carefully examined in light of the actual provisions of foreign law. For example, under the

[199] Reg. §31.3401(a)(8)(A)-1(b)(3).

[200] *See, e.g*, Rev. Rul. 74-435 (Vaud cantonal tax on net profits, imposed by Swiss Canton of Vaud, is creditable under §901).

[201] *See* the discussion in 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

[202] Note that certain provisions of §1.901-1 are effectively suspended or modified by Notice 2023-55, modified by Notice 2023-80, which would appear to permit taxpayers to rely on the historical interpretation of "income tax" for purposes of section §3401(a)(8)(A)(ii).

[203] The Social Security Amendments of 1977, Pub. L. No. 95-216, §317(b)(4), 91 Stat. 1540, provides, "Notwithstanding any other provision of law, taxes paid by any individual to any foreign country with respect to any period of employment or self-employment which is covered under the social security system of such foreign country in accordance with the terms of an agreement entered into pursuant to section 233 of the Social Security Act shall not, under the income tax laws of the United States, be deductible by, or creditable against the income tax of, any such individual." This provision of Pub. L. No. 95-216, enacted in 1977, was not codified into the Internal Revenue Code. *See* 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes* for an additional discussion.



ISBN 978-1-61746-986-2

laws of certain foreign countries with "remittance systems," the employee and the employer may have arranged to reduce foreign income taxes by taking advantage of rules in the foreign tax law permitting certain remuneration to escape foreign tax if it is paid outside the country and not remitted to the employee in the foreign country where he or she resides. To the extent that foreign taxes are reduced under such a rule, the foreign wage withholding exemption of §3401(a)(8)(A)(ii) would not be available. However, the exemption probably would be available if remuneration is fully subject to foreign withholding tax, but special deductions available to foreign nationals are allowed in computing the rate of withholding tax and of substantive personal tax liability.

*g. Noncompliance with Foreign Withholding Law*

To the extent that an employer compensates a U.S. citizen employee working abroad under a "split payroll" whereby a certain portion of total remuneration is paid to him or her in the United States and is not declared in the foreign country, in violation of the foreign country's tax laws, the question arises whether U.S. wage withholding tax applies when wage withholding is "required" under foreign law (the statutory test of §3401(a)(8)(A)(ii)), even though the foreign wage withholding tax is not actually withheld and paid over to the foreign government in accordance with its law. Such an argument may be technically correct in light of the literal language of the Code and the regulations. However, the IRS ruled inTAM 8351004 that "compliance by the employer with the foreign country's withholding tax law" is implicit in the §3401(a)(8)(A)(ii) exemption.

*h. Withholding Agreement with Foreign Government*

Where wage withholding is technically required under the laws of a foreign country but where an agreement is entered into between a U.S. employer and a foreign government to substitute direct collection by the foreign government from the employees themselves rather than from the wages they receive from their employer, the IRS has ruled that the foreign wage withholding requirement of §3401(a)(8)(A)(ii) is satisfied, and that no U.S. wage withholding is required.[204]

*i. Supplemental Wages*

As discussed in II.E.4., above, if an employer pays a bonus or other type of supplemental wages to an employee, the employer may elect to withhold at the flat rate of 25%[205] under the "optional flat rate" method — provided that the total amount of all supplemental wage payments for the year does not exceed $1 million and that the employer is thus required to withhold at the highest tax rate applicable under §1 for the taxable years beginning in that calendar year. This mandatory flat rate is applied without regard to 1) whether income tax has been withheld from the employee's regular wages; 2) any entries on Form W-4, including whether the employee has claimed exempt status on Form W-4, or whether the employee has requested additional withholding on Form W-4; and 3) the withholding method used by the employer.[206] For U.S. citizens working outside the United States who are part of a tax reimbursement program maintained by their employer, if a particular payment is not subject to mandatory flat rate withholding, the employer would usually not elect to use the optional flat rate method if that resulted in cash flow problems for the employee, and instead would use the "aggregate procedure" which in effect treats the payment as part of regular salary. The reason is because foreign tax credits with respect to the supplemental wages that are reflected on the employee's Form W-4 may not be taken into account under either the optional flat rate method or the mandatory flat rate method, but they *can* be considered under the aggregate method. Thus, if the supplemental wages are not otherwise exempt from U.S. wage withholding under one of the exemptions mentioned above (for example, the §911 exemption, or the foreign-wage-withholding exemption), serious cash flow problems could occur.

If the mandatory flat rate withholding method is required to be used, however, the employer may be required to withhold U.S. tax on part or all of the payment at the applicable rate, and the fact that the employee may be subject to significant foreign income taxes on the payment may not be used to reduce the U.S. wage withholding tax because foreign tax credits that are reflected on the employee's Form W-4 may not be used to reduce the U.S. withholding. If the payment is subject to foreign wage withholding tax, however, even at a very low rate, it should be excluded from wages under §3401(a)(8)(A)(ii), and thus it is likely that no U.S. wage withholding tax would be imposed on the payment. In certain foreign countries where the payment is taxable, however, either the payment may be excluded from the country's wage withholding tax or there may be no wage withholding tax imposed generally on employees. Therefore, if the employee is required to make current estimated tax payments to the foreign country on the payment, cash flow problems will occur (since Form W-4 cannot be used to claim foreign tax credits that might reduce the U.S. withholding tax) until the employee files his or her U.S. return to claim a refund of the withheld tax.[207] If payment of the foreign tax cannot be postponed, planning may be needed in order to subject the payment to some kind of foreign withholding tax, or possibly to reduce the amount of the payment temporarily below the $1 million threshold. In this regard, if the payment is not subject to withholding tax under the foreign country's general income tax laws but if it is subject to the country's social security tax or unemployment tax, that would often exempt the payment from U.S. wage withholding tax under §3401(a)(8)(A)(ii), even if the foreign withholding rate is low. *See* the discussion in VI.A.4.d., above. If the U.S. employer cannot avoid U.S. withholding and if the employee cannot avoid a simulta-

[204] Rev. Rul. 79-392. This ruling was distinguished in CCA 200814010, where the U.S. employer proposed to enter into a special wage withholding arrangement with the government of the foreign country, but where the laws of the foreign country did not provide for wage withholding.

[205] Reg. §31.3402(g)-1(a)(7)(iii)(F) provides that the withholding rate is either 28% for supplemental wages paid after 2004, or the corresponding rate in effect under §1(i)(2) for taxable years beginning in the calendar year in which the payment is made. *But see* §1(j) (providing modifications to the tax rate in certain years).

[206] Reg. §31.3402(g)-1(a)(2).

[207] The employee would typically claim a foreign tax credit for the foreign income tax paid on the payment, probably on the accrued basis (if the individual employee has elected to use the accrual tax accounting method), and as a result would be entitled to a refund of some or all of the U.S. wage withholding tax. He or she would then use the refunded U.S. tax to pay the foreign tax on the payment.



ISBN 978-1-61746-986-2

neous requirement to make estimated tax payments to the foreign country, the U.S. employer might also consider advancing funds to the employee to pay the foreign estimated tax, with the loan to be repaid to the employer after the employee files his or her U.S. tax return for the year and receives a refund of the U.S. withholding tax.

Alternatively, part of the payment may be subject to the foreign country's general wage withholding tax on compensation, but part may not. In that case, only the portion that is not subject to foreign wage withholding tax would be taken into account for purposes of the $1 million rule. For example, it is common for U.S. citizens working in some countries to be paid salary for working in that country through a local subsidiary that withholds the country's wage withholding tax on that salary, but for salary allocable to business trips outside the country to be paid by a U.S. company without foreign wage withholding tax. If a bonus of $1,200,000 is paid to a U.S. citizen with two employment contracts of this nature and if the payment is made one-half by each company (i.e., $600,000 by the foreign subsidiary and subject to foreign wage withholding tax and $600,000 by the U.S. parent company with no foreign wage withholding tax), the $1 million threshold would not be satisfied because only $600,000 of the total payment would be wages for §3401(a) purposes.

*5. Adjustment to Reflect Foreign Tax Credits*

U.S. citizen employees working outside the United States may furnish Form W-4 to their employer reflecting the amount of foreign tax credit that they expect to claim as a reduction of their personal income tax for the year, in accordance with the provisions of §3402(m)(2). Worksheet 8 of IRS Publication 919 (rev. February 2011), *How Do I Adjust My Tax Withholding?*, shows how to convert foreign tax credits (and other credits) into the correct number of withholding allowances on Form W-4.

U.S. citizen employees working abroad need to complete a Form W-4 showing expected foreign tax credits only where their remuneration was not otherwise excluded under §911 or subject to foreign wage withholding tax. For example, an employee who worked abroad for a period of less than 11 months would not qualify for the §911 exclusion and also might not be subject to mandatory wage withholding under foreign law. Similarly, a highly paid employee working abroad might well receive salary in excess of the §911 exclusion which might not be subject to foreign wage withholding tax.

As noted immediately above, U.S. wage withholding tax on payments of supplemental wages may not be reduced to reflect foreign tax credits reflected on Form W-4 if either the "optional" or "mandatory" flat rate method applies.

*6. Employee Who Expects No U.S. Tax Liability*

Section 3402(n) provides for a wage withholding exemption if an employee certifies to the employer on Form W-4 that:

(1) he or she had no federal income tax liability in the preceding taxable year; and

(2) he or she expects that he or she will have no liability for income tax in the current year.

Many U.S. citizens who have been working abroad for more than one year would qualify for this exemption because of the combination of the §911 exclusion and the foreign tax credit, particularly if they work in foreign countries where the effective income tax rates are higher than in the United States. This rule thus offers such employees a simple procedure for handling U.S. wage withholding tax without having to make a formal §911 statement and without making the numerical computations that are required on Form W-4 with respect to anticipated foreign tax credits.

*7. Business Days in the United States*

To the extent that a U.S. citizen employee who normally works abroad spends time working in the United States, either due to business trips or due to a short-term change in the location of remote work, none of the wage withholding exemptions described in VI.A.1. through VI.A.5., above, are theoretically available. This is because the exclusions under §911, §931, and §933 are only available with respect to foreign-source income. In contrast, remuneration for services performed within the United States (regardless of the identity of the employer and the place of payment) is U.S.-source income. The foreign wage withholding exemption is also not available, even if foreign law requires foreign wage withholding tax to be withheld on the citizen's business trips back to the United States, because §3401(a)(8)(A)(ii) requires that the employee's services be performed in a foreign country. Finally, the foreign tax credit could not be utilized to reduce U.S. tax on salary allocable to U.S. business days, because the foreign tax credit may only reduce U.S. tax on foreign-source income.[208]

Even though remuneration for U.S. business days is includible in the U.S. citizen employee's gross income, it is quite possible that no actual personal tax liability will result. This is because the income will qualify for reduction by the standard deduction, personal exemptions, and deductions which may not have to be allocated to foreign-source income.[209] If a U.S. citizen employee's remuneration for U.S. business days is expected to be fully offset in this way, he or she would be exempt from wage withholding. However, if the employer anticipated that the employee would visit the United States and perform business services, it would technically be required to withhold on the allocable portion of total remuneration unless the employee furnished it with a Form W-4 which claimed exception from withholding tax under §3402(n) (discussed in VI.A.6., immediately above), if such a claim were proper.

Under Reg. §1.861-4(b)(2)(ii)(B), a U.S. citizen working full-time outside the United States is required to source certain specified fringe benefits on a geographical basis (e.g., at the employee's principal place of work), rather than allocating any portion of them to U.S. business trips. This rule applies to housing, education, local transportation, tax reimbursement, hazardous or hardship duty pay and moving expense reimbursement fringe benefits, as defined in Reg. §1.861-4(b)(2)(ii)(D)*(1)* through *(6)*, which also contains the individual geographical sourcing rule for each category of fringe benefit. The

[208] §904(a).

[209] *See Personal Exemption Tables* and *Standard Deduction Tables by Year* in Federal Tax Tables, Charts & Lists for personal exemption amounts and standard deduction amounts, respectively, in recent years. Several tax deductions previously available to individuals were suspended for taxable years 2018 through 2025. Pub. L. No. 115-97, §11041–§11051.



ISBN 978-1-61746-986-2

taxpayer would be required to treat as U.S.-source income any portion of any other taxable fringe benefits allocable on a time basis to U.S. business trips.[210] Any portion of taxable fringe benefits sourced to the United States would be subject to U.S. wage withholding.

If the U.S. citizen qualifies for an exemption from wage withholding tax on salary allocable to his or her foreign workdays during the particular pay period and if his or her U.S. workdays are less than half of the total workdays in the pay period, an exemption from wage withholding may be available under the "included/excluded" rule of §3402(e), discussed in II.C.6., above.

Under many U.S. income tax treaties, the United States has agreed to re-source U.S.-source compensation realized by a U.S. citizen or resident who is resident in the treaty country so that it is sourced in the treaty country for foreign tax credit purposes, provided that the U.S.-source compensation is subject to income tax under the laws of the treaty country. In TAM 7907010, the taxpayer was a U.S. citizen who was resident in Belgium for Belgian income tax purposes made business trips to the United States. The taxpayer's U.S.-source compensation was subject to Belgian income tax under Belgian law. The IRS ruled under Article 23(2) of the U.S.-Belgium Income Tax Treaty that the compensation allocable to U.S. business trips was reclassified as Belgian-source income for U.S. foreign tax credit purposes, even though it clearly remained subject to U.S. income tax. Similarly, in Rev. Rul. 79-206, the IRS ruled that compensation received by a U.S. citizen residing in Japan for personal services performed in the United States as a flight crew member on international flights for a Japanese airline was treated as Japanese-source income for U.S. foreign tax credit limitation purposes, on the basis of the re-sourcing rules of Article 6(6) of the former U.S.-Japan Income Tax Treaty.[211]

*Comment:* Historically, such re-sourcing rules were often advantageous to U.S. citizens or residents who were resident in a high-tax country such that they had excess foreign tax credits arising with respect to salary allocable to work outside the United States. A taxpayer's ability to credit such foreign taxes, however, may be limited by the more restrictive foreign tax credit rules published in 2022.[212]

*8. Withholding if No Exemption Applies*

*a. General*

To the extent that a U.S. citizen receives remuneration for services for working outside the United States and an exemption from U.S. wage withholding is not available under any of the rules discussed above, the employer is technically required to withhold U.S. tax from the employee's remuneration. This is the case even if the employer is not a U.S. person, and even if it is a foreign person with no U.S. owners. Further, the employee might be subject to foreign income tax on his or her remuneration, but only on a self-assessed (estimated tax) basis with no wage withholding obligation imposed on the employer under foreign law. Although the employee might provide Form W-4 to the employer in order to reduce the amount of U.S. wage withholding tax so as to reflect the employee's foreign tax credits, the employee's foreign tax credits may not completely eliminate his or her U.S. tax, and thus there would be residual U.S. wage withholding liability on the part of the employer with respect to at least some of the employee's remuneration.

*b. U.S. Employer*

If the employer is a U.S. company and if no withholding exemption is available with respect to the U.S. citizen employee working outside the United States, it is likely that the employer will have a U.S. payroll system. Thus, the employer will treat the employee's remuneration in the same manner as if the employee were based in the United States and made no business trips abroad.

*c. Foreign Employer with Part or Full U.S. Ownership*

If the employer is incorporated under the laws of a foreign country and is wholly owned by a U.S. parent company and if none of the wage withholding exceptions is available with respect to the U.S. citizen employee working abroad, the foreign employer is required to withhold from the employee's remuneration in the same manner as if the employer were a U.S. company. It is important to note that the fact that the employer is wholly owned by a U.S. company is not relevant for this purpose — the wage withholding rules of §3401 have a "global" scope, and there is no exception that is available based on the facts of the particular individual's employment.

This particular situation often arises when a U.S. citizen works for the foreign subsidiary of a U.S. parent company in a low-tax jurisdiction. The employee's service might be provided in the same country where the foreign employer is incorporated, or possibly in a third country where the employee's salary might be exempt from income tax for one of several reasons. Structuring the individual's employment through a foreign subsidiary might be done for corporate tax reasons, or possibly to exempt the employee's salary from U.S. social security tax (provided that no "FICA election" has been made under §3121(l)).[213]

As mentioned earlier, the foreign employer is required to comply with the U.S. wage withholding rules (if no exemption is available under §3401), regardless of whether the U.S. company owns a majority interest in the foreign employer, a 50% interest, a very small interest, or no interest whatsoever.[214] (This rule is in clear contrast with the U.S. social security tax rule, which imposes the FICA tax on U.S. citizens working outside the United States for a foreign entity only if the foreign entity is at least 10% owned by an "American employer" (as specially defined),[215] *and* if the U.S. person who owns an equity interest in the foreign employer affirmatively elects FICA cov-

[210] Reg. §1.861-4(b)(2)(ii)(A).

[211] Rev. Rul. 79-206, amplifying Rev. Rul. 79-28.

[212] *See* TD 9959, published in the Federal Register (87 FR 276) on January 4, 2022.

[213] *See* 6830 T.M., *International Aspects of U.S. Social Security Taxes and Unemployment Taxes.*

[214] *See* Reg. §31.3401(a)-1(b)(7), defining "wages" to include remuneration for services performed by a U.S. citizen or resident as an employee of a nonresident alien individual, foreign partnership, or foreign corporation. In accordance with §3402(a)(1), all employers making payment of wages are subject to the requirement of withholding.

[215] *See* §3121(h).



ISBN 978-1-61746-986-2

erage for those U.S. citizens under §3121(l).)[216] If a U.S. company that has an ownership interest in the foreign employer assists the foreign company in disbursing salary to its employees, the U.S. company could be considered to be the "employer" for wage withholding purposes under §3401(d)(1) or §3401(d)(2), discussed above.

*d. Foreign Employer with No U.S. Contacts*

Even if the U.S. citizen's employer is a foreign company that is entirely owned by foreign persons, the same U.S. wage withholding obligations apply to the employer. If the employer happens to be engaged in a U.S. trade or business through a U.S. branch office that has a U.S. payroll system, it may be possible to include the U.S. citizen working abroad in that payroll system, even though his or her employment may have no connection with the operations of the U.S. branch office. However, if the foreign employer is not engaged in a U.S. trade or business, it is still technically required to withhold U.S. wage withholding tax from the U.S. citizen's remuneration if no exemption is available under §3401.

As if to stress this point, Reg. §31.3401(a)-1(b)(7) states expressly that the term "wages" includes remuneration for services performed by a "citizen or resident" as an employee of a foreign person "whether or not such [foreign person] is engaged in trade or business within the United States." The regulation continues by referring to the "disbursing agent" rule in Reg. §31.3401(d)-1(e) and §31.3401(d)-1(f), which provides that any person who has legal control over the payment of wages or who pays wages on behalf of the actual employer is himself or herself also considered to be the employer for purposes of wage withholding tax liability. This rule is clearly designed to give the IRS jurisdiction to collect wage withholding tax in situations where the actual employer may have no business presence or assets in the United States, but where remuneration which is subject to U.S. wage withholding tax is disbursed by a payroll agent who is subject to IRS collecting jurisdiction.

Notwithstanding the long-arm reach of the withholding tax rules, one has to question the feasibility of any IRS attempts to collect wage withholding tax from foreign employers which are not controlled by U.S. shareholders and which have no operations, assets, or disbursing agents in the United States. To the extent that a U.S. citizen employee of such an employer has substantive U.S. tax liability, however, he or she should obviously make timely payments of such tax to the IRS, on an estimated tax basis if required under the law.

*9. Wage Withholding by U.S. Disbursing Agent*

Although a foreign employer that is controlled by foreign owners and that has no U.S. assets or business presence may not be subject to U.S. wage withholding tax in practice (as discussed in VI.A.8.d., above), the IRS might very well attempt to collect wage withholding tax from foreign employers that are partially or fully controlled by U.S. shareholders (*see* VI.A.8.b. and VI.A.8.c., above). An obvious situation in which the IRS might attempt to enforce the literal language of the withholding rules would be where a related U.S. company maintained the payroll system on behalf of the foreign employer.

For example, assume that a U.S. construction company forms a Bermuda subsidiary to perform a construction contract in the Middle East. United States citizen employees are seconded to the Bermuda company to render services on behalf of the Bermuda company in completing the contract. Because of the short-term duration of the contract, the employees do not qualify for the §911 exclusion, and because there is no personal income tax law in the country where they work, no foreign wage withholding tax is imposed on their remuneration and no foreign tax credits are anticipated that will reduce the employees' U.S. personal income tax liability. Under the literal language of §3401(a), the remuneration paid by the Bermuda company is "wages" subject to U.S. wage withholding tax because it does not qualify for any of the exemptions in §3401 or §3402.

If the Bermuda company maintains its own payroll outside the United States either in Bermuda or in the Middle East, it is possible that the IRS might attempt to enforce the company's U.S. wage withholding tax obligations. In many situations, however, the payroll system for the Bermuda company will be maintained by the Bermuda company's U.S. parent company, or by a related U.S. company in the parent's consolidated U.S. tax group. If this occurs, the U.S. company could fall within the "disbursing agent" rule of Reg. §31.3401(d)-1(e) and (f), and could thus be treated as the "employer." As such, the U.S. company would be subject to the U.S. wage withholding tax jointly with the Bermuda company.

*10. Estimated Tax Liability*

A U.S. citizen employee working abroad may be required to make estimated tax payments in the event that U.S. wage withholding tax (if any) on his or her remuneration is insufficient to cover his or her personal tax liability for the year. This could occur in the following situations:

- The employer is required to withhold U.S. wage withholding tax, but fails to do so, or fails to withhold the amount required under the U.S. rules. Presumably, this would frequently happen in the case of a foreign-controlled foreign employer with no U.S. business presence. Underwithholding might also occur in the case of a U.S. employer for a number of reasons.

- The employer is exempt from U.S. wage withholding under §3401(a)(8)(A)(ii) because the remuneration is subject to foreign wage withholding tax, but the foreign tax is imposed at a very low rate.

- Events which the employees expected to occur during the year might not occur. For example, the employee may fail to qualify for the §911 exclusion, or the employee's allowable foreign tax credits may turn out to be less than anticipated.

As soon as a U.S. citizen employee working abroad expects that he or she may have a federal income tax liability for the year that may not be fully covered by wage withholding tax, the relevant rules on imposition of the §6654 penalty for un-

[216] For purposes of FICA withholding, "employment" does not include services performed outside the United States for a non-U.S. employer. *See* §3121(b). *See also* CCA 202327014, primarily addressing the taxation of Restricted Stock Units (RSUs), where personal services performed outside the United States for a non-U.S. employer did not qualify as "employment" as defined in §3121(b), and therefore were not subject to FICA withholding. For more information on FICA taxes, *see* 6830 T.M., *International Aspects of U.S. Social Security Taxes and Unemployment Taxes.*



ISBN 978-1-61746-986-2

derpayment of estimated tax should be considered. If the employee believes that the §6654 penalty might be imposed, he or she should make the necessary estimated tax payments, or else request the employer on Form W-4 to withhold additional amounts under §3402(i).

*11. Practical Implications*

Because U.S. citizens working abroad often have little or no substantive U.S. tax liability on their compensation, a U.S. employer that transfers or permits U.S. citizens to work abroad may be tempted to stop U.S. withholding when the foreign assignment begins. The principal reason for non-compliance with the literal requirements of the law is that it can be quite expensive for an employer to observe all the complexities of the wage withholding rules on U.S. citizens abroad, in view of the often very small amount of net U.S. tax that must be withheld. If the employee anticipates that he or she will have some U.S. tax liability on his or her salary — because of U.S. business trips, or insufficient foreign tax credits — the employer should assist the employee in calculating the amount of his or her expected U.S. tax for the year and in calculating the necessary estimated tax payments. Even if the employee makes estimated tax payments in order to satisfy any shortfall in U.S. wage withholding tax, there would nevertheless remain the possibility that the employer could be assessed for interest and penalties.

Although in practice many employers do not attempt to match a particular U.S. citizen's facts with the various exemptions under the wage withholding rules, an employer who simply stops withholding on a foreign-based U.S. citizen employee should always be cautioned that if the IRS undertakes a payroll audit of the employer or a review of the foreign-based U.S. citizens' Forms W-4 and uncovers significant amounts of apparent underwithholding, it could require the employer to withhold on those employees in full with as little as one withholding allowance.[217]

*12. Employees of Foreign Governments and International Organizations*

Section 3401(a)(5) provides for a wage withholding exemption in the case of all citizens and residents employed by a foreign government or international organization. As discussed above in V.B.3.b., whether a similar exemption would be available to employees of a foreign corporation that is wholly owned by a foreign government probably depends on the nature of the corporation's activities.

### *B. Resident Aliens*

Like U.S. citizens, resident aliens are subject to U.S. income tax on their worldwide income. Although the territorial rule described in V.A., above, for nonresident aliens generally does not apply, certain variations of the territorial rule do apply.

*1. Determining Alien's Status as a Resident*

As discussed in I.C.2., above, the rules under §7701(b) that determine whether an individual is a resident alien or a nonresident alien can be quite complex, and in many cases an individual's status for the year will not be known until the end of the year, or often until sometime during the following calendar year. In the case of an employee working substantially full-time outside the United States, however, it is often easier to ascertain the individual's status at a particular moment. If the individual is a non-immigrant alien under the U.S. immigration laws, the individual will usually be classified as a nonresident alien, because he or she will be unlikely to spend enough days in the United States each year to be classified as a resident alien under the "substantial presence" test of §7701(b)(3). If he or she has a "green card" (permanent residence immigration visa), however, he or she will usually be classified as a resident alien unless the "tie-breaker" provisions of an income tax treaty make him or her resident in the foreign country where he or she resides.

*2. No Special Section 3401(a) Exception*

The definition of "wages" in §3401(a) contains no special exceptions for resident aliens working outside the United States. As discussed in V.A., above, §3401(a)(6) and the regulations thereunder exempt nonresident alien employees from withholding on remuneration for work done outside the United States, and as discussed in VI.A., above, §3401(a)(8) contains withholding exemptions for U.S. citizens who expect to qualify for exclusion under §911, §931, or §933, or whose remuneration is subject to wage withholding under foreign law. In contrast, resident aliens whose remuneration is expected to be excluded under §911, §931, or §933, or which is subject to foreign wage withholding tax, are technically subject to U.S. wage withholding tax. This gap in the statute is presumably a legislative oversight, and one may question the wisdom of enforcement of the literal language of §3401(a) so as to require wage withholding on resident aliens, at least where the remuneration is expected to be excluded from gross income in the hands of the employee. In Rev. Rul. 92-106,[218] however, the IRS ruled that no exemption from wage withholding is available to a U.S. resident alien for the amount received by the taxpayer for services performed abroad that is excludible under §911. Further, after publication of Rev. Rul. 92-106, the IRS revised Form 673 so as to delete any reference to the fact that resident aliens could use the form as well as U.S. citizens.

If the resident alien is a citizen of a country which has an income tax treaty with the United States containing an appropriate "non-discrimination clause," then it seems likely that the §3401(a) wage withholding exemptions available to a U.S. citizen should also be available to the resident alien.[219] This conclusion is not absolutely certain, however, because the §3402 wage withholding tax is technically imposed on the employer and not on the employee, although it is withheld by the employer from the employee's wages. If the resident alien is not a resident of a treaty partner, however, any wage withholding

[217] Reg. §31.3402(f)(2)-1(g).

[218] The IRS reaffirmed this conclusion in CCA 200814010.

[219] *See* Rev. Rul. 91-58, listing those treaties that effectively allow a citizen from those countries to claim the "bona fide foreign residence" exclusion in addition to the "physical presence" test exclusion that is otherwise allowed to both U.S. citizens and resident aliens under the Code. Rev. Rul. 91-58 is based on a prior ruling, Rev. Rul. 72-330, amplified by Rev. Rul. 72-598, which listed those tax treaties that allowed citizens from those countries to claim the §911 "physical presence" exclusion available to U.S. citizens. At that time, the "physical presence" exclusion was available only to U.S. citizens and not to resident aliens, as at present.



ISBN 978-1-61746-986-2

exemptions available to him or her must be sought in §3401(a) itself.

### 3. *Remuneration Excluded from Employee's Gross Income*

Precedent for ignoring the literal language of §3401(a), which imposes wage withholding on a resident alien's remuneration even though it will be excluded from his or her gross income under §911, can be found in the IRS regulations and rulings which expand the §3401(a) exceptions to include items which will be excluded from the employee's gross income but which are not specifically excepted from the definition of "wages" in §3401(a) itself. As discussed in II.B.2., above, the regulations under §3401(a) exempt from wage withholding employer contributions to group health plans (excluded from the employee's gross income under §106) and meals and lodging that are excludible from the employee's gross income under §119, even though §3401(a) itself does not provide for a wage withholding exception in the case of such items.

To the extent that a resident alien employee's remuneration is expected to be excluded from gross income under §911, it is reasonable for the employer to claim a U.S. wage withholding exemption for such employees, provided that the procedures applicable to U.S. citizens are followed. Thus, if the employer wishes to exempt withholding on remuneration that is expected to be excluded under the 330-day "physical presence" test of §911(d)(1)(B), the rules in the applicable regulations should be followed.[220] A similar argument can be made to exempt U.S. wage withholding on remuneration paid to individuals resident in Puerto Rico or the other U.S. possessions who expect to exclude their remuneration from U.S. gross income under §931 or §933, and under the other rules that apply to individuals resident in the U.S. possessions.

### 4. *Remuneration Subject to Foreign Wage Withholding Tax*

It is more difficult to argue that the §3401(a)(8)(A)(ii) exemption (for remuneration subject to foreign wage withholding tax) may be claimed by an employer with respect to a resident alien employee. As explained in VI.A.4., above, the exemption is available in the case of a U.S. citizen employee even if the rate of foreign wage withholding is extremely low, and even if as a result the employee may have to make estimated tax payments in order to make up the difference between his or her expected foreign tax credits and his or her U.S. tax on the foreign income.

A conservative view would be that an employer should not claim the §3401(a)(8)(A)(ii) exemption with respect to a resident alien employee, since it is more difficult to analogize this exemption to the withholding exemption for income that will clearly be excluded from the resident alien's gross income. Because the foreign tax that is withheld by the employer will usually be claimed as a foreign tax credit by the resident alien employee, however, the employee presumably can claim a reduction in the amount of his or her U.S. wage withholding tax by furnishing a Form W-4 to the employer which reflects his or her anticipated foreign tax credits. As a result, in most cases there should be little or no adverse cash flow problem to the employee because of continued withholding on remuneration which is subject to foreign wage withholding tax.

If a portion of the resident alien employee's remuneration is eligible for the §911 exclusion, however, that portion of his or her remuneration should probably be exempted from withholding entirely, as discussed above. Any excess remuneration that is not excluded under §911 would then be subject to U.S. wage withholding tax, without exemption from U.S. withholding because of the foreign wage withholding rule in §3401(a)(8)(A)(ii), but with a reduction in U.S. wage withholding to the extent that Form W-4 shows a reduction in substantive tax liability to reflect foreign tax credits.

### 5. *Form W-4 May Be Used to Reduce U.S. Withholding*

A resident alien may furnish Form W-4 to the employer so as to reduce his or her U.S. wage withholding tax to reflect anticipated deductions and credits, such as the foreign tax credit. This rule is to be contrasted with that in §3402(f)(6), discussed in V.C.1., above, which permits most nonresident aliens to claim only one withholding exemption.

If a resident alien expects no federal income tax liability for the current year and had no liability for the preceding year, he or she may also claim full exemption from U.S. withholding tax under §3402(n), discussed in VI.A.6., above, by claiming full exemption from withholding on Form W-4. An employee working abroad might have no U.S. tax liability as the result of one or more factors, including the §911 exclusion, foreign tax credits, and allowable deductions and other credits.

Form W-4 does not provide for a reduction in withholding to reflect anticipated exclusions from gross income, but only anticipated deductions and credits. Exclusions may be reflected on Form W-4 only if a complete exemption from withholding is claimed under §3402(n), as discussed above. The fact that Form W-4 technically cannot be used by a resident alien to reduce his or her withholding tax to reflect an expected §911 exclusion is another argument in favor of the practical approach exempting such remuneration from withholding.

### 6. *Employees Classified as Residents of a Treaty Country*

An unusual withholding tax question may be posed if an employee who is classified as a resident alien under the Code is also classified under an income tax treaty as a resident of the foreign country where he or she lives. This can occur under the "tie-breaker" rule of a number of treaties. For example, under most U.S. income tax treaties,[221] an individual who is classified as a resident of both countries under their respective tax laws is classified for treaty purposes as a resident of the country where he or she maintains his or her "permanent home." Typically, a resident of the treaty partner may not be taxed by the United States on remuneration received as an employee unless it is received for work done within the United States.[222] In light of these treaty provisions, remuneration which is includible in the gross income of a resident alien under the Code but which

[220] Reg. §31.3401(a)(8)(A)-1(a), discussed in VI.A.1., above.

[221] See, e.g., Article 4(3) of the U.S. Model Income Tax Convention.

[222] See, e.g., Article 14 of the U.S. Model Income Tax Convention.



ISBN 978-1-61746-986-2

is excludible under a tax treaty is excluded from the individual's gross income. A resident alien classified as a resident of a tax treaty country under the treaty rules would thus be exempt from U.S. substantive liability in most cases on remuneration for work done as an employee outside the United States.

This situation can arise in one of two ways. First, the individual may hold a U.S. permanent residence visa ("green card") and be classified as a resident alien under §7701(b)(1)(A)(i). Second, he or she may be classified as a resident alien under the "substantial presence" test of §7701(b)(1)(A)(ii) and §7701(b)(3).[223]

If a resident alien is treated as a resident of a treaty country and claims that status, the §7701(b) regulations provide that he or she is required to file his or her U.S. tax return for all purposes as a nonresident alien.[224] In this case he or she would fall under the §3401(a)(6) regulations, and would be exempt from wage withholding on all salary for work done outside the United States.

A more complex issue for a treaty tie-breaker alien who holds a green card is whether claiming residence in the treaty country and filing his or her U.S. return as a nonresident alien (in accordance with the §7701(b) regulations) might affect the continued holding of his or her green card.[225] For this reason cautious green card holders living in qualifying tax treaty countries often continue to file their U.S. tax returns as resident aliens rather than as nonresident aliens.

*7. Business Trips Back to the United States*

A resident alien employee working abroad is subject to the same rules as U.S. citizen employees regarding business trips back to, or temporary working arrangements in, the United States, discussed in VI.A.7., above. Thus, the §911 exclusion is not available with respect to the allocable U.S. portion of his or her remuneration (subject to the special U.S. sourcing rules with respect to employer-provided fringe benefits), nor may foreign credits reduce the U.S. tax on such portion.

As discussed in V.B.6., above, an individual who is classified as a nonresident alien who is also resident in a country having an income tax treaty with the United States, is often exempt from U.S. income tax on salary allocable to business trips made to, or temporary working arrangements in, the United States. Thus, if an individual who is a resident alien under the Code is reclassified under a treaty as a nonresident alien who is resident in the treaty country, salary allocable to U.S. workdays could be exempt from U.S. tax, and thus exempt from U.S. wage withholding tax.

*8. Foreign Employer with No U.S. Contacts*

As discussed in VI.A.8.c. and VI.A.8.d., the language of §3401(a) can impose wage withholding requirements on foreign employers with no U.S. owners and no U.S. assets. Reg. §31.3401(a)-1(b)(7) reinforces this point by stating that a foreign employer of a citizen or a resident alien employee is subject to U.S. wage withholding tax even if the employer is not engaged in business within the United States. Accordingly, the problems discussed above would arise with respect to resident aliens working abroad as well as for U.S. citizens abroad.

*9. Employees of Foreign Governments and International Organizations*

As discussed in VI.A.12., above, a resident alien employed by a foreign government or international organization may be exempt from wage withholding tax.

### *C. IRS Reporting Even if No Wage Withholding*

As discussed in II.I., above, an employer may be required to furnish Form W-2 to an employee at year-end even if remuneration paid to the employee is exempt from wage withholding tax. Quarterly filing of Form 941 may also be required, even though during certain calendar quarters no U.S. federal employment taxes need to be withheld and/or deposited. *See* the further discussion in XIII., below.

### *D. Identifying Employees Who Are U.S. Citizens or Resident Aliens*

The U.S. wage withholding rules clearly require that an employer (whether U.S. or foreign) withhold U.S. income tax from the remuneration of every U.S. citizen and resident alien employee if none of the exceptions in the Code or the regulations is available. The question thus arises as to how the employer can know which of its employees working outside the United States is a U.S. citizen or resident alien. In those situations where the employee has been sent or permitted to work abroad from the United States, the employer will often have information about the employee's status based on the employee's prior work experience. In particular, if the employee is sent from the United States to work in a foreign country having a social security totalization agreement with the United States and if steps are taken to keep the employee in the U.S. social security system, with rare exceptions this can only be done if the employee is either a U.S. citizen or a resident alien who will retain resident alien status while working abroad (i.e., if the resident alien is a U.S. immigrant holding a "green card"). On the other hand, if the employee is hired locally or from elsewhere outside the United States, it may be difficult for the employer to ascertain whether the employee is a U.S. citizen or resident alien, particularly if the employee is in fact a U.S. citizen or resident alien but does not wish to disclose this fact to the employer.

There does not appear to be any guidance in the Code or the regulations on this issue. If an employer believes that a particular employee is a *nonresident* alien but if the employee is in fact a U.S. citizen or resident alien, there is apparently no "safe haven" on which an employer can rely in order to protect itself from a U.S. wage withholding tax assessment by the IRS if it turns out that the employer is wrong. As a technical matter, this issue could probably not arise if the employee is in fact a U.S. citizen but if the employee's remuneration is subject to foreign wage withholding, because in that situation the remuneration would be exempt from U.S. wage withholding under the foreign-wage-withholding tax exception of §3401(a)(8)(A)

[223] *See* the discussion in 6400 T.M, *U.S. Income Taxation of Nonresident Alien Individuals.*

[224] Reg. §301.7701(b)-7. The individual is required to attach IRS Form 8833, or an equivalent statement.

[225] Reg. §301.7701(b)-7(b) specifically warns about this issue.



ISBN 978-1-61746-986-2

(ii).[226] As noted above, it is also possible that a *de facto* U.S. wage withholding exemption is available for both U.S. citizen and resident alien employees to the extent that various foreign exclusions and foreign tax credits are available to an employee, even if not specifically claimed by the employee in a document that he or she gives to the employer.

Special problems may also arise where an individual who is classified as a nonresident alien under the Code makes an election under §6013(g) to be classified as a resident alien. Although §6013(g)(1)(B) provides that the election is effective for wage withholding tax purposes (as discussed in V.D., above), the employee might not inform the employer of this status, or the election might not be made until after the end of the taxable year. In the reverse situation, an individual who is clearly a resident alien under the Code might make a "treaty tiebreaker election" to be classified as a nonresident alien (as discussed in VI.B.6., above). Presumably in that situation the employee would be more likely to promptly inform the employer of the election in order to be exempt from U.S. wage withholding tax, but again the election might not be made until the employee files his or her U.S. tax return for the year, by which time the wages for the taxable year will already have been paid in full.

It is not clear how often the IRS actually conducts extensive payroll tax audits of employers with foreign-based employees, or when it does, how likely it is that the IRS might actually learn about such individuals. This issue can nevertheless result in substantial U.S. tax avoidance in the case of very highly-compensated U.S. citizen or resident alien employees who work in low-tax or no-tax foreign countries. Thus, if an employer wishes to protect itself from the risk of an IRS assessment, it should ask the employee to certify his or her nonresident alien tax status with as much supporting documentation as possible, even though that documentation still might not protect the employer from a withholding tax assessment if it turns out to be wrong. In this regard, the employer may consider adopting screening procedures that follow some or all of the U.S. FATCA rules that are applied in order to determine the citizenship and residence of individuals who maintain foreign brokerage accounts.[227] In certain doubtful cases, the employer might even choose to hold back funds from the employee's remuneration until the statute of limitations to assess wage withholding tax on the employer has expired.[228]

### *E. Employees of Foreign Disregarded Entities*

As discussed in II.J., above, since 2009 the Treasury regulations have treated foreign disregarded entities as separate entities for U.S. employment tax purposes, i.e., for social security tax (FICA), federal unemployment tax (FUTA), and wage withholding under §3401. It has become increasingly common for U.S. parent companies owning foreign disregarded entities to utilize those entities for FICA planning purposes, because unless the U.S. parent makes a §3121(l) election to cover U.S. employees working for the disregarded entity for FICA purposes, substantial savings can often be achieved in the form of both employer and employee FICA.[229]

If a U.S. citizen or resident alien works outside the United States as the employee of a foreign disregarded entity, the U.S. wage withholding obligations (if any) are imposed on the disregarded entity itself, and not on its U.S. parent company. Because the business results of the disregarded entity would be consolidated with the U.S. owner's results for U.S. corporate income tax purposes, the disregarded entity would usually have no reluctance to comply in full with the U.S. wage withholding requirements — in contrast with a foreign-owned foreign employer that may be concerned that complying with the U.S. wage withholding rules could expose it to U.S. corporate income taxation.[230]

### *F. "Common Law Employees" of a U.S. Corporation*

If a U.S. citizen or resident alien employee is sent or is permitted to work outside the United States by a U.S. corporation but cannot be kept on the payroll of the sending U.S. company (and cannot be placed onto the payroll of a foreign affiliate of a U.S. company), the question of how to maintain U.S. social security (FICA) coverage for the individual often arises.[231] Often it is possible to take the position that the individual remains a "common law employee" of the U.S. company that sent or permitted the employee to work outside the United States, even though the U.S. company does not pay the individual's salary and never has physical custody of the salary. The common law employee argument is based on the fact that the "sending" U.S. company arguably has direction and control over the individual (rather than the foreign employer of record), particularly the right to discharge the individual.[232] The applicable FICA regulation is contained in Reg. §31.3121(d)-1(c)(2). For U.S. wage withholding purposes the same rule is contained in Reg. §31.3401(c)-1(b). This argument is typically made by the sending U.S. company, although in theory the IRS could make the same argument in situations where the U.S. company did not want to be considered the common law employer.

In the context of FICA, the U.S. sending company is liable for both employer and employee FICA on behalf of the common law employee, even though the U.S. company does not pay the salary and never has custody of the salary. Thus, the U.S. company pays both the employer and employee portions of FICA out of its own funds, although it may subsequently re-

[226] If the employee wants the employer to believe that he or she is a nonresident alien, the employee would not give a Form 673 to the employer in order to claim the §911 exclusion, nor would the employee give the employer IRS Form W-4 in order to claim withholding allowances based on foreign tax credits, or in order to claim an exemption from withholding based on the likelihood of no U.S. income tax for the year under §3402(n).

[227] §1471–§1474.

[228] Unless the employee has a U.S. social security number and the employer knows the number, it would probably not be possible for the employer to do "protective" U.S. wage withholding, and then leave it to the employee to file a claim for refund at the end of the year on the basis of his or her asserted nonresident alien tax status.

[229] *See* the discussion of this issue in 6830 T.M, *International Aspects of U.S. Social Security and Unemployment Taxes. See also* Thomas Bissell, *Planning Opportunities under New Employment Tax Rules for Foreign Disregarded Entities*, 40 Tax Mgmt. Int'l J. 185 (Mar. 11, 2011).

[230] *See* V.G., above. *See also* VI.A.8.d. and VI.B.8., above.

[231] This situation typically arises where the individual is sent or permitted to work for a foreign parent company, a foreign sister company of a common foreign parent, or for a foreign-owned foreign company that has no economic relationship with the sending U.S. company.

[232] *See* the discussion of this issue in 6830 T.M, *International Aspects of U.S. Social Security and Unemployment Taxes.*



ISBN 978-1-61746-986-2

quest reimbursement for these amounts from the foreign company and/or from the employee.

If a U.S. company is in fact the common law employer of a U.S. citizen or resident alien who is working outside the United States on the payroll of a foreign company, the question arises whether the U.S. company would also be required to withhold U.S. wage withholding tax on behalf of the same individual — if none of the wage withholding exceptions discussed above is available. Although the answer is not entirely clear, it appears that the same company cannot be held liable for the wage withholding tax unless it has some involvement with the payment of the individual's salary. Thus, §3401(d)(1) provides an exception from the definition of the term "employer" for wage withholding purposes "if the person for whom the person performs or performed the services does not have control of the payment of the wages for such services … ." In that case, "the person having control of the payment of such wages" is deemed to be the employer, and thus is required to do the required wage withholding. Thus, if the foreign company has exclusive control over the remuneration paid to the individual, presumably it is the foreign company that must do the U.S. wage withholding (assuming that no exception is available). If the foreign company did not comply with the U.S. rules, however, and if there were payments made between the two companies that did not specifically relate to the individual's salary, the IRS might argue that the U.S. company had *de facto* control over funds that were indirectly used to pay the individual's salary.

### *G. Mandatory FICA Coverage for Foreign Entities Under Section 3121(z)*

In 2008, Congress became concerned about situations in which U.S. contractors agreed to provide services to the U.S. government in Iraq and Afghanistan, and then subcontracted the work to foreign subsidiaries that were not covered by a FICA election. In order to require those companies to provide FICA coverage to U.S. citizen and resident alien employees of those foreign subsidiaries, Congress enacted §3121(z) as part of the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, effective for services performed in calendar months beginning after July 17, 2008.[233]

Under §3121(z), a foreign person that performs services under contract with the U.S. government (or any instrumentality thereof) and that is part of a domestically controlled group of entities is treated as an "American employer" for FICA purposes.[234] Thus, services performed as an employee for such an employer outside of the United States by a U.S. citizen or resident alien in connection with such a contract is employment that is subject to FICA tax, unless one of three exceptions applies.[235] As such, the foreign company is required to pay both employer and employee FICA as if the individual were its own employee, and in addition the U.S. parent company is "jointly and severally liable" for the FICA taxes.[236]

Although §3121(z) clearly imposes the requirement to pay FICA taxes on the U.S. parent company if the foreign company fails to comply, it has no apparent effect for U.S. wage withholding purposes. Thus, the foreign company remains liable to pay U.S. wage withholding tax on remuneration paid to U.S. citizens and resident aliens if no exception applies, and if it fails to do so, §3121(z) does not impose any liability on the U.S. parent. If the U.S. parent has some involvement with the payment of the remuneration, of course, the U.S. parent could be deemed to be an employer who is subject to the wage withholding rules under §3401(d)(1).

---

[233] Pub. L. No. 110-245, §302.

[234] §3121(z)(1). *See* the discussion of this issue in 6830 T.M, *International Aspects of U.S. Social Security and Unemployment Taxes.*

[235] The three exceptions are that (1) the individual is covered by a so-called FICA election that the U.S. parent has made under §3121(1), (2) the individual is covered by a foreign country's social security tax that is substantially equivalent to FICA, or (3) the individual is exempt from FICA under a social security totalization agreement between the United States and a foreign country.

[236] §3121(z)(3).



ISBN 978-1-61746-986-2

## VII. Nonresident Aliens Working Outside the United States as Employees

There are apparently no situations in which a nonresident alien employee is subject to wage withholding tax on remuneration for services performed outside the United States. As discussed in VI.D., above, however, the IRS rules contain no guidance on how an employer can know whether an employee is a U.S. citizen, resident alien, or nonresident alien. In practice, if the employee has been hired locally within the foreign country or elsewhere outside the United States and if the employer has no reason to believe that the employee may be a U.S. citizen or resident alien, and in particular if the employer does not have a U.S. social security number for the employee, the employer is unlikely to include the employee in its U.S. payroll system. In contrast, if the employee worked for the employer within the United States prior to the transfer, the employer may very well include the employee in its U.S. payroll system. If the employee did not have a U.S. "green card" while working in the United States and instead held a non-immigrant visa, it is likely that the employee will become a nonresident under the U.S. "substantial presence" test either when the transfer takes place, or within a period of months thereafter. Similarly, if the employee did hold a green card while working in the United States but gave it up when he or she transferred abroad, the employee is also likely to become a nonresident alien shortly thereafter. In either case, however, the employee should notify the employer promptly as soon as he or she believes that resident alien status has terminated, in order to avoid the overwithholding of U.S. tax that might otherwise occur.

As discussed in VI.D., above, even though an individual is classified as a nonresident alien under the Code for a particular taxable year, in some cases this status might not be determined until after the end of the year, for example, if the individual is a green card holder who takes a treaty tie-breaker tax return position as a nonresident alien but only when the return is filed after the end of the year in which wages were paid by the employer and subject to U.S. wage withholding tax. In such a situation, however, if the treaty tie-breaker position is correct, the employee would be entitled to a refund of the withheld taxes.



ISBN 978-1-61746-986-2

## VIII. Self-Employed U.S. Citizens and Resident Aliens Working in the United States

### *A. General Rules*

Because U.S. citizens and resident aliens are not subject to §1441 withholding, there are no withholding or reporting obligations imposed on the payor of compensation for services to a self-employed U.S. individual working in the United States unless the payor is engaged in a trade or business. If the payor is so engaged and if the payment is connected with the payor's trade or business, then in most cases the payor will be required to report the payment on IRS Form 1099-NEC under §6041 and/or §6041A, and thus the payment will be a "reportable payment" for backup withholding tax purposes under §3406. Accordingly, the payor must request Form W-9 from the payee, and do backup withholding on the payment if the form is not timely received.

As discussed further in IX., below, there is no safe harbor for a payor who reasonably believes that the payee is a U.S. citizen or a resident alien, but where the payee in fact turns out to be a nonresident alien. This problem is compounded by the fact that it may not be known on the payment date how the alien is in fact classified: in many cases this classification determination will not be known until the end of the year or (if the individual is classified as a nonresident alien under the Code but is permitted to elect resident alien status) possibly not until the individual files his or her U.S. income tax return for the year. If the payee is in fact a nonresident alien, withholding under §1441 is generally required even if the payor is not engaged in a trade or business. Based on the lack of IRS rulings and court decisions on this issue, however, it is quite possible that this issue rarely arises in practice.

As noted in III.A.5., above, the obligation on the part of the payor to request Form W-9 from the payee is technically imposed not only on payors that are U.S. persons, but also on foreign persons. For example, if a foreign corporation pays compensation for services to a U.S. citizen or resident alien for work done in the United States, technically the payor in most cases is required to obtain a timely Form W-9 from the payee and file Form 1099-NEC with the IRS at year-end. If Form W-9 is not obtained, then the payor is required to do backup withholding.

### *B. Resident Aliens from Certain Tax Treaty Countries*

A number of income tax treaties exempt from U.S. income tax certain categories of individuals who are classified as resident aliens under the Code but who are classified as nonimmigrants under the U.S. immigration laws. The principal categories are teachers, students, researchers, and trainees.[237] Although an individual in one of these categories usually would not be classified as self-employed for U.S. tax purposes, any compensation for services paid to such an individual would be exempt from U.S. tax under the treaty. In that situation, the payee would provide a timely IRS Form 8833 to the payor. It does not appear that the payor would be required to file Form 1099-MISC with the IRS, because Prop. Reg. §1.6041A-1(a)(1) provides that reporting is not required if the "service-recipient [i.e., the payor] knows that such amounts are excludable from the gross income of the person performing such services." Based on this regulation, the payment would not be a "reportable payment" under §3406 for backup withholding purposes, nor would §1441 withholding be required because of the payee's resident alien status. Because the payee's U.S. taxpayer identification number would appear on Form 8833, however, that form would operate in the same manner as would Form W-9, if the rules of §3405 were to apply.[238]

*Editor's Note:* The final regulations of §3405 have now been issued in October of 2024.[239]

### *C. Foreign Governments and International Organizations*

Remuneration paid to U.S. citizens and resident aliens who work within the United States as self-employed consultants to foreign governments or international organizations may well be exempt from Form 1099-MISC reporting under international law, notwithstanding the absence of an exception in the §6041(a) and §6041A regulations.[240] Thus, even though the recipient may be taxable on such remuneration (for example, if he or she is a U.S. citizen or resident alien), it is unlikely that the IRS attempts to enforce the literal language of §6041(a) and §6041A against such payors.

---

[237] *See* the discussion in 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

[238] *See* §31.3405(e)-1 for questions and answers regarding applicability of §3405 to various scenarios.

[239] §31.3405(e)-1.

[240] There are exceptions in Reg. §1.6041-3(p)(5) and §1.6041-3(p)(6) with respect to payments made to foreign governments and international organizations, but the only exception for payments made by a foreign government or international organization is in Reg. §1.6041-3(k), which exempts certain travel allowances paid by international organizations. The implication is that other types of remuneration for services paid by international organizations, such as salary and self-employed service fees, are subject to §6041 reporting.



ISBN 978-1-61746-986-2

## IX. Self-Employed Nonresident Aliens Working in the United States

### A. *Self-Employed Nonresident Aliens and U.S. Citizens Compared*

By far the most complex U.S. withholding and reporting rules involving self-employed workers in a cross-border context are the rules that apply to self-employed nonresident aliens working in the United States.

As discussed in III., above, where a nonresident alien individual performs services in the United States as a self-employed independent contractor rather than as an employee, a separate set of withholding rules is applied. Because the payee is not an employee, the wage withholding rules of chapter 24 of the Code do not apply. Instead, compensation for services received by the payee is subject to withholding at the flat rate of 30% under §1441, because such fees are considered to be fixed or determinable annual or periodical gains, profits, and income (FDAP). As discussed further below, however, the rules governing substantive tax liability are more complex, because the compensation is almost always taxed at graduated personal income tax rates as effectively connected income under §871(b). These rules are in contrast with the withholding and reporting rules that apply to self-employed U.S. citizens and resident aliens working in the United States, who are instead subject to the Form 1099-NEC reporting rules of §6041 and §6041A, and potentially to the backup withholding rules of §3406.

This section discusses the withholding rules governing payments made to self-employed nonresident aliens under §1441. Additional observations concerning withholding on compensation for services paid to foreign partnerships and foreign corporations are contained in IX.I., below. Further discussion of the U.S. withholding rules is in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*.

### B. *General Rules*

#### 1. *U.S.-Source Income Only*

Withholding at source under §1441 is intended to enforce a nonresident alien's substantive income tax liability for the 30% tax imposed under §871(a)(1) with respect to a number of items of U.S.-source income. Section 1441(a) imposes a broad withholding tax on the payors of U.S.-source income items described in §1441(b). Thus, self-employment income which is paid to a nonresident alien and which is classified as foreign-source income is exempt from §1441 withholding.[241] Based on the source rules in §862(a)(3), this means that payments for work done by a nonresident alien outside the United States are exempt from withholding under §1441, and also exempt from substantive liability under §871(a)(1). In addition, such income can never be taxed at graduated rates as effectively connected income under §871(b), because §864(c)(4) does not include foreign-source services income among the categories of foreign-source income that may be taxed as effectively connected income.

#### 2. *Withholding Even if Income Is Effectively Connected*

The 30% withholding requirement under §1441 covers not only self-employment income but also certain kinds of "passive" income such as dividends, interest and royalties. Because §1441 is intended to operate in tandem with the rules imposing 30% substantive liability under §871(a)(1), a limited exception from the 30% withholding obligation under §1441 is available if the item of income is effectively connected with the conduct of a U.S. trade or business in the hands of the nonresident alien recipient. However, the language of §1441(c)(1) that exempts from 30% withholding items of income which are effectively connected, contains an exception for income that is "compensation for personal services." Under §1441(c)(4), the extent to which U.S.-source compensation for personal services may be exempt from 30% withholding is to be determined by regulations.

The regulations on this question draw a curious distinction between self-employed nonresident alien individuals, on the one hand, and foreign partnerships and foreign corporations receiving U.S.-source compensation for services on the other. The regulations state specifically that an exemption from 30% withholding is available in the case of "income for services performed by a foreign partnership or a foreign corporation" (other than a personal holding company) if the income is effectively connected with a U.S. trade or business of the recipient, but that the exemption from withholding "shall not apply to compensation for personal services performed by an individual."[242] A case-by-case exception discussed in IX.D.5., below, may be available if the individual applies to the IRS in advance for relief.

The requirement that 30% tax be withheld by the payor of self-employment income to a nonresident alien gives rise to an obvious disparity between the withholding liability and the recipient's substantive liability. It is arguable that any item of U.S.-source services income received by a foreign person, whether a self-employed nonresident alien, a foreign partnership, or a foreign corporation, by definition is effectively connected with the conduct of a trade or business within the United States, because by definition it cannot be U.S.-source income subject to tax unless one or more individuals were physically present in the United States to render the services. Indeed, the IRS expressed its view in Rev. Rul. 78-234 that a foreign corporation performing any services in the United States through its employees is deemed to be engaged in a U.S. trade or business. In addition, §864(b) provides that "the term 'trade or business within the United States' includes the performance of personal services within the United States at any time within the taxable year … ."

Thus, it may be argued that, in any situation where a nonresident alien is subject to 30% withholding at source on U.S.-source self-employment compensation for services, the individual's substantive liability is not at the 30% rate on "passive" U.S.-source-income under §871(a)(1), but instead is at the graduated rates applicable to effectively connected income

[241] Reg. §1.1441-1(b)(4)(v), §1.1441-2(a).

[242] Reg. §1.1441-4(a)(1), §1.1441-4(b).



ISBN 978-1-61746-986-2

under §871(b).[243] Accordingly, a nonresident alien whose U.S.-source self-employment income is subject to 30% withholding tax at source would be required at the end of the year to report such income on Form 1040NR and compute his or her tax on a net basis (after claiming allowable deductions) at the applicable graduated rates. If the taxpayer's final liability is less than the 30% tax withheld at source, the taxpayer would be entitled to a refund, but if the taxpayer's final tax liability is greater, then additional tax must be paid by the taxpayer either when the return is filed, or possibly in the form of estimated tax payments prior to the filing of the return. For a discussion of withholding by domestic partnerships on payments to foreign partners or partnerships, *see* 6680 T.M., *Partners and Partnerships — International Tax Aspects*.

*3. Identity of Payor and Place of Payment*

As discussed above with respect to remuneration paid to an employee, the wage withholding rules usually determine withholding liability on the basis of the tax status of the employee and the place where the employee renders services. The identity of the payor and the place where payment is made or received are frequently not relevant. Thus, if a foreign corporation with no U.S. business presence or assets pays salary into a foreign bank account for the benefit of an employee performing services within the United States, the payment may nevertheless be subject to U.S. wage withholding tax.

A similar rule applies for U.S.-source remuneration for services paid to a self-employed nonresident alien. Thus, the liability of the payor to withhold under §1441 applies even though the payor may be a foreign person with no business presence or assets in the United States, and even though the payment may be made into a foreign bank account maintained by the payee. This rule raises obvious IRS enforcement problems, similar to the enforcement questions raised by the wage withholding liability of a foreign employer whose employees visit the United States on business trips. The person paying remuneration for services to a self-employed nonresident alien would usually not have day-to-day control over the individual's activities or, in the case of services supplied remotely, even over the individual's actual location at the time the services are performed. In such a situation, it is hard to see how the payor would even know whether any portion of the fees was U.S.-source income subject to §1441 withholding, and if so what portion was so subject.

*4. Payor's Knowledge of the Section 1441 Withholding Requirements*

To be aware of the applicable §1441 withholding obligations, the person compensating a self-employed individual for services must know (or have reason to know) two things:

(1) that the person receiving the compensation is a self-employed nonresident alien individual; and

(2) that part or all of the services for which the compensation is paid were rendered by the nonresident alien within the United States.

However, in many cases the payor will not know whether the recipient is a nonresident alien or a resident alien for federal income tax purposes. Because an employer would exercise the degree of control over an employee that would usually provide knowledge at least of the employee's citizenship and/or immigration status, an employer would often have a fairly good idea, if not definite knowledge, whether the employee should be treated as a resident or as a nonresident alien for federal income tax purposes. However, the client of a self-employed individual frequently would have no knowledge of these matters, and little or no information sufficient to form a reasonable belief about the recipient's U.S. tax status.

The regulations impose a fairly rigid standard on the payor in this situation. Reg. §1.1441-1(b)(1) provides that the payor of U.S.-source income that is described in §1441 must withhold 30% tax from the payment "unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a payee that is a U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding." In most cases the documentation that must be relied upon is Form W-8BEN or Form 8233 if the payee is a nonresident alien, or Form W-9 in the case of a U.S. citizen or resident alien.

In the absence of such documentation, however, the regulations provide for some complicated presumptions. Reg. §1.1441-1(b)(3)(iii) provides that "[a] payment that the withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person … ." As a result, backup withholding must be done at the applicable rate under §3406.[244] However, if the payor has actual knowledge or "reason to know" that the payee is a nonresident alien, then withholding must be done under §1441 at the statutory 30% rate.[245]

If the payment is made with respect to an "offshore obligation" (presumably in the form of a wire transfer to a foreign bank account maintained by the payee),[246] then the payee is presumed to be a "foreign" person (i.e., a non-U.S. person) unless the payor has "actual knowledge" that the payee is a U.S. person (in this case, a U.S. citizen or resident alien). If the nonresident alien presumption applies, then 30% withholding tax is imposed under §1441, but if the payor has actual knowledge that the payee is a U.S. citizen or resident alien, then backup withholding is imposed under §3406.

[243] *See* discussion in III.C., above.

[244] Section 3406(a)(1) provides that in the case of any reportable payment (which includes any payment required to be shown on a return required under §6041 or §6041A among others), under certain circumstances, the payor must deduct and withhold a tax equal to the product of the fourth lowest rate of tax applicable under §1(c) and the payment. *But see* §1(j) (modifying the rate in §1(c) for certain years).

[245] Reg. §1.1441-1(b)(3)(ix)(B). This rule applies so long as the 30% rate under §1441 is higher than the current backup withholding rate under §3406. If at some time in the future the backup withholding rate ever exceeds the 30% withholding rate under §1441, then the presumption of U.S. status is conclusive and cannot be rebutted by actual knowledge that the payee is a nonresident alien. *See* Reg. §1.1441-1(b)(3)(x) *Ex.* 2, which is substantially similar to an earlier version of that example that was published when the backup withholding rate was 31%, i.e., when it was higher than the 30% rate under §1441.

[246] Reg. §1.1441-1(b)(3)(iii)(D).



ISBN 978-1-61746-986-2

Finally, Reg. §1.1441-1(b)(3)(iii)(E) contains an odd rule which provides that payments for services are presumed to be made to a nonresident alien if four tests are all met:

(1) the payee is an individual;

(2) the payor does not know, or have reason to know, that the payee is a U.S. citizen or resident alien;

(3) the payor does not know, or have reason to know, that the income is (or may be) effectively connected with the conduct of a trade or business within the United States; *and*

(4) all of the services were performed by the payee outside the United States.

Accordingly, under the regulation, backup withholding is not required under §3406 if a payment of entirely foreign-source compensation for services is made to an individual and the payor has neither actual knowledge, nor reason to know, that the payee is a U.S. citizen or resident alien. The regulations under §6041 and §6041A, discussed in X.B., below, appear to confirm this interpretation.

Therefore, to summarize the rules that are applied under §1441 with respect to U.S.-source compensation for services, if a U.S. or foreign payor intends to make a payment to an individual for services that were partially or entirely performed within the United States and if the individual is not the payor's employee (a fact that the payor should be able to ascertain), before making the payment the payor should request the payee to provide documentation as to the payee's U.S. tax status. If the payee is a U.S. citizen or resident alien, the payee will give the payor Form W-9, which will include the payee's U.S. social security number and other information. If the payee is a nonresident alien, the payee will instead give the payor either Form W-8BEN or Form 8233, which should either include the payee's ITIN (individual taxpayer identification number) or an indication that it has been applied for.[247] If the payee does not give the payor any documentation, then the various presumptions in the §1441 regulations must be considered. As discussed above, in general the payee will be presumed to be a U.S. person and the payor will be required to withhold U.S. backup withholding at the rate of 25%, unless the payor has actual knowledge or "reason to know" that the payee is a nonresident alien, in which case withholding will be at the 30% rate under §1441. However, if the payment is made into a foreign account and the payor does not have *actual* knowledge that the payee is a U.S. person, in that situation the payor should withhold from the U.S.-source portion of the payment at the §1441 rate of 30% on the presumption that the payee is a nonresident alien. (If the payor does have actual knowledge that the payee is a U.S. person, then withholding would be at the current backup withholding rate.)

Where the payor is a U.S. person engaged in a trade or business, compliance with the rules described above should be relatively straightforward because U.S. companies routinely request Form W-9, or equivalent information, from individuals they compensate for services. Any person engaged in a trade or business is required to provide Form 1099-NEC to self-employed individuals from whom it receives services and to impose backup withholding at the applicable rate under §3406 if it does not receive a proper Form W-9, as discussed in III., above. If the payee provides the payor with Form W-8BEN instead of Form W-9, then the payor would comply with the §1441 rules, as discussed in this section.

Assuming that the payor knows about the requirement to obtain documentation from the payee, the question arises as to how the payor can know how much of the payment is for services that were rendered within the United States (and thus subject to 30% withholding under §1441), and how much was not (and thus exempt from §1441 and all other U.S. withholding tax). The payor will often know or have reason to know, but in many cases it will not. Although the law and the §1441 regulations are silent on this question, it would appear that the payor is at its peril if it assumes that the U.S.-source portion of the fees is less than it actually is. To protect itself from possible penalties, therefore, the payor should either withhold on the full amount of the fees paid to the nonresident alien, or should request the payee to furnish a statement allocating the compensation between U.S.- and foreign-source income. It should be noted, however, that there is no express authority in the §1441 regulations authorizing a payor to request or to rely on such a statement.

If a payor withholds an amount which, based on the actual facts, turns out to be more than the correct amount of tax, §1461 provides that the payor is "indemnified against the claims and demands of any person" by reason of any overwithholding that may occur. Thus, if a payor wishes to be cautious and withholds on the full amount of a payment that it may have reason to believe is partially or fully exempt from withholding, it is presumably protected against any claim from the payee for the lost use of the withheld funds prior to the date the payee recovers the funds from the IRS as a tax refund.

If the payor is a *non-U.S.* person, such as a foreign corporation, it is much less likely to know about its potential liability for §1441 withholding tax on the U.S.-source portion of the compensation for services it pays to a self-employed nonresident alien. How well the IRS polices this area is not clear, but enforcement is probably not any better in this area than in the area of nonresident alien employees from non-treaty countries who work briefly in the United States and who fail the §861(a)(3) "de minimis" exception (discussed in V., above).

Finally, mention should be made of both U.S. and foreign persons who are not engaged in a trade or business and who make payments to self-employed individuals. This group includes homeowners who make payments to self-employed contractors for home repairs and construction work, as well as payments made to self-employed professionals such as doctors, attorneys, and accountants where the services received by the client are of a personal nature and not connected with a business that the client operates. Because the payor is not engaged in a trade or business, if the payee is a U.S. citizen or resident alien, there is no obligation for the payor to provide Form 1099-NEC to the payee and to the IRS at year-end, and thus no obligation to ask the payee to give the payor a Form W-9 that includes the payee's social security number (or other taxpayer identification number). In this situation, therefore, it would be unusual for the payor to ask the payee for any IRS documentation.

[247] *See* the instructions to Form W-8BEN.



ISBN 978-1-61746-986-2

Notwithstanding the fact that the payor of a non-business service fee would usually not request any IRS documentation from the payee, one could argue that the portions of the §1441 regulations discussed above apply in a non-business context as well as in a business context. If they do apply and if the payor does not request the payee for IRS documentation, the regulations presume in the absence of such documentation that:

(1) the payee is a U.S. person, and accordingly no backup withholding is required because of the payor's non-business status; and

(2) at the same time no withholding tax will be imposed on the payor under §1441.

However, if the payor has "actual knowledge" or "reason to know" that the payee is a nonresident alien rendering services within the United States, then 30% withholding tax under §1441 is imposed. If the facts are such that the payee is in fact a nonresident alien, but if the payor has no actual knowledge or reason to know of that status, then apparently the §1441 tax that clearly applies under the law will not be imposed on the payor (although the payee will still be subject to U.S. income tax liability on the payment under §871). In any event, the IRS probably does not enforce compliance with any of these rules where the payor is not engaged in a trade or business, although situations can be imagined where the payor should be advised to carefully consider the applicable rules.[248]

*5. Return-on-Capital Income Versus Services Income*

The §1441 regulations do not make a clear distinction between self-employment income of a nonresident alien that is realized from the rendering of personal services, and self-employment income that is realized from invested capital. This distinction does appear in a number of other parts of the Code, including §401(c)(2), relating to self-employment retirement plans; §911, exclusion from gross income of foreign-source earned income; and §1402(a)(12), exempting certain kinds of self-employment income from invested capital from the social security self-employment tax.

In Rev. Rul. 70-543, the IRS ruled that where U.S.-source self-employment income is realized entirely from invested capital, the nonresident alien receiving the income is entitled to claim exemption from 30% withholding at source under §1441, provided that he or she furnishes a statement to the payor of the income certifying that the income is effectively connected with a U.S. trade or business. In the facts of Example (3) of the ruling, a nonresident alien owner of racehorses enters several horses in U.S. horse races and pays for the cost of jockeys, entrance fees, stable expenses, and other fees. The IRS ruled that winnings received by the nonresident alien "are not compensation for personal services" within the meaning of §1441(c)(1), and thus the individual is entitled to file the same "effectively connected" statement (then IRS Form 4224) and claim an exemption from withholding.

The ruling does not deal with other fact patterns in which self-employment income might be allocable in part to services rendered by the nonresident alien, and in part to capital invested by the individual in his or her sole proprietorship. However, the ruling does suggest that minimal services may be rendered by the self-employed nonresident alien without exposing any of his or her self-employment income to 30% withholding. Based on the regulations under other parts of the Code, however, if both personal services and capital are "material income producing factors," a "reasonable allowance" as compensation for personal services rendered personally by the nonresident alien may be made, but in no event more than 30% of total self-employment income.[249] These rules suggest that if capital is a material income-producing factor in the production of a nonresident alien's self-employment income, the portion of any compensation subject to 30% withholding should not exceed 30% of such compensation. Since withholding is imposed on a gross basis, this would mean that the maximum rate of withholding on the U.S.-source portion of such compensation would be 9% (i.e, 30% tax times the 30% deemed earned-income portion of the compensation). Because there is no authority in the §1441 regulations for taking this position, however, a payor should withhold at the full 30% rate in the absence of express permission from the IRS to withhold at a lower rate (*see* IX.D.5., below).

*6. Self-Employed Status Is Not Elective*

As indicated in II. and III., above, whether the recipient of compensation for services is an employee for wage withholding purposes or a self-employed individual is determined by an objective analysis of all the facts. Neither status is elective. Thus, it is not possible for a nonresident alien who is an employee to elect to be classified as self-employed, or vice versa, nor may the payor of compensation for services make such an election with respect to the payee.

### *C. Procedures Where No Withholding Exemption Applies*

*1. General Comments*

U.S. companies typically are not permitted to pay nonresident aliens who would be classified as employees for federal tax purposes for work in the United States unless the employee has obtained a U.S. nonimmigrant work visa, On the other hand, U.S. companies may compensate self-employed nonresident aliens who visit the United States on a non-immigrant business visitor (B-1) visa for work done in the United States. To the extent that a nonresident alien on a B-1 visa works temporarily in the United States, in most cases the individual is an employee whose salary is being paid by a foreign employer; in such a situation, the IRS typically would have little or no information about the employer's business operations. In contrast, a U.S. payor of U.S.-source compensation for services to a self-

[248] For example, a high-net-worth U.S. citizen might engage the services of a nonresident alien attorney to assist him or her in complex issues involving the individual's holdings of real estate in a foreign country, as well as related foreign estate planning. If the foreign attorney visits the United States for extensive meetings, the U.S. client's payments for services would presumably be subject to 30% withholding under §1441 if the payee is deemed to be a nonresident alien, either because (1) the payment is made to him or her by wire transfer into a foreign bank account (Reg. §1.1441-1(b)(3)(iii)(D)) or (2) payment is made directly to the attorney, and, despite the presumption that the payee is a U.S. person who is exempt from backup withholding, the payor has either actual knowledge, or "reason to know," that the payee is a nonresident alien, and thus the payor is liable for withholding tax at the 30% rate under §1441 because that rate exceeds the zero rate that would apply if the payee were a U.S. person (Reg. §1.1441-1(b)(3)(ix)(B)).

[249] Reg. §1.911-3(b)(2).



ISBN 978-1-61746-986-2

employed nonresident alien will typically claim the payment as an income tax deduction on its U.S. income tax return, and it may become more common for IRS agents who audit the returns of U.S. payors to follow this "audit trail," and assess either backup withholding or §1441 withholding where the payor did not obtain proper documentation from the nonresident alien payee. Thus, it may still be difficult for the IRS to enforce the §1441 regulations against foreign payors, but not so difficult to enforce them against U.S. payors.

If a payor does not comply with the §1441 rules and the IRS subsequently audits the payor and imposes either §1441 tax or §3406 backup withholding tax, the payor may attempt to claim reimbursement from the foreign payee. In many cases, however, it may be difficult for the payor to collect the tax from the payee. If the foreign payee has complied with the substantive U.S. tax liability that is imposed under §871(b) in the meantime, the withholding tax may not be due but interest and penalties could nevertheless be imposed on the payor.

### 2. *Section 1441 Procedures Where No Exemption Applies*

To comply with the §1441 regulations, a payor of U.S.-source compensation for services to a nonresident alien must ask the payee to complete the appropriate IRS form in order to certify that the payee is a nonresident alien and thus that the payment is subject to 30% withholding tax.[250] As noted earlier, in most, if not all, situations the payment of compensations for services rendered in the United States will be effectively connected with the conduct of a trade or business within the United States (so-called "effectively connected income," or ECI). The fact that the payment will be ECI in the hands of the nonresident alien payee but at the same time will be subject to 30% withholding under §1441 has, unfortunately, not been dealt with adequately in the IRS forms and in their instructions.

To certify that the payee is a nonresident alien, the payee must complete one of two IRS forms in the W-8 series — either Form W-8BEN or Form W-8ECI. The Form W-8BEN and its instructions warn that the form is not be used if the U.S.-source income is ECI. Instead, Form W-8ECI and its instructions provide that it is the correct form for the nonresident alien to give the payor, if the payee believes that the payment is ECI. However, IRS Publication 515 notes in one part that "effectively connected income for which a valid Form W-8ECI has been provided is generally not subject to NRA withholding"[251] while also noting in another part that in general U.S.-source fees paid to a self-employed nonresident alien are generally subject to 30% withholding. If U.S.-source compensation for services paid to a self-employed nonresident alien were in fact non-ECI, then Form W-8BEN is the correct form for the payee to provide to the payor, as it is for other kinds of non-ECI, such as U.S.-source dividends, interest, and royalties. In the typical situation where the compensation for services is ECI though, it is not clear whether the payee should use Form W-8BEN or Form W-8ECI. In practice it probably does not matter, so long as the payor is aware of its obligation to withhold 30% tax on the payment under §1441, and does in fact comply with its withholding obligation.

To complicate matters further, a third IRS form — Form 8233 — may be used by a self-employed nonresident alien who wishes to reduce the §1441 withholding tax on U.S.-source compensation for services, to reflect the daily personal exemption amount (discussed below). If a self-employed nonresident alien provides Form 8233 to the payor to claim the daily personal exemption amount, the payor should be careful to comply with the applicable §1441 withholding tax rules on the gross payments (but net of the daily personal exemption amount). As discussed further below, Form 8233 is also used by self-employed nonresident aliens to claim a complete exemption from U.S. withholding tax under the terms of an income tax treaty between the United States and the country of the alien's residence.

Whichever IRS form is used by the nonresident alien (whether Form W-8BEN, Form W-8ECI, or Form 8233), the form is required to include an ITIN (Individual Taxpayer Identification Number), or else the payee's U.S. social security number (if, for example, the payee is engaged in authorized employment within the United States or obtained a social security number in a prior year in connection with authorized U.S. employment sometime in the past). Although obtaining an ITIN can be a burdensome requirement for many nonresident aliens, in many cases the 30% withheld under §1441 will be more than the self-employed individual's substantive tax liability on the payment under §871(b). Thus, the individual will often want to obtain an ITIN in order to show it on a Form 1040NR that the individual will file after the end of the year in order to claim a refund of part or all of the withheld tax. If the payee provides no documentation to the payor, then the payor will withhold either 30% tax under §1441 or backup withholding under §3406, and if the payee wishes to obtain a refund for part or all of this tax, it may be more difficult to prove to the IRS that the withheld tax was for the account of that particular individual, and not for the account of someone else.

As discussed above, the payor is required to receive proper IRS documentation from a self-employed nonresident alien (whether on Form W-8BEN, Form W-8ECI, or Form 8233), without regard to whether the payor is itself a U.S. person or a foreign person. As indicated above, however, IRS enforcement of the §1441 regulations in this area is much more likely to be targeted at U.S. payors rather than at foreign payors.

### 3. *Prorated Personal Exemption*

Reg. §1.1441-4(b)(6)(i) provides that the payor of self-employment income may reduce the amount of withholding tax to reflect the payee's personal exemption (allowable under §873(b)(3)).[252] In effect, the payee indicates on the form how many days of services were performed within the United States, and the payor then subtracts a pro rata daily amount from the gross payment that is subject to withholding under §1441. Nonresident aliens from Canada, Mexico, and certain treaty countries may claim additional prorated exemptions to

[250] Reg. §1.1441-1(e)(2)(ii). If an exemption from §1441 withholding tax is claimed under the Code or under a treaty, or a reduced rate of withholding tax is claimed under a treaty, Form 8233 is required to be used instead.

[251] IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*

[252] *See Personal Exemption Tables* in Federal Tax Tables, Charts & Lists for personal exemption amounts in recent years under §151.



ISBN 978-1-61746-986-2

reflect qualifying dependents, and so specific income tax treaties should be consulted.

*4. Filing Form 1042 and Form 1042S*

The regulatory rules under section 1461 require the payor to file Form 1042 and Form 1042S after the end of the year to report all payments that were subject to withholding under §1441 during the year.[253] Civil (and potentially criminal) penalties may be imposed for nonfiling or for late filing of these forms.[254]

### *D. Exceptions from Section 1441 Withholding*

The §1441 regulations contain a number of exceptions from the 30% withholding tax in the case of compensation for personal services of a nonresident alien individual.[255] In general these exceptions are comparable to those under the wage withholding regulations, but with certain important differences.

*1. Compensation of Certain Canadians and Mexicans*

Reg. §1.1441-4(b)(1)(iii) provides an exemption from 30% withholding in the case of "services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the United States at frequent intervals … ." This regulation is limited to Canadian and Mexican residents who are self-employed, because such residents working as employees are covered by the wage withholding rules in Reg. §31.3401(a)(6)-1.

The §1441 regulations quoted immediately above appear on their face to grant an extremely broad withholding exemption to all self-employed Canadian and Mexican residents who visit the United States on regularly recurring business trips. The question arises whether the Treasury intended to limit the scope of the withholding exemption to nonresident aliens doing the same kind of work as Canadian and Mexican employees described in Reg. §31.3401(a)(6)-1(c)(3), discussed in V.B.4., above. Those regulations provide that Canadian and Mexican residents working as employees in "transportation service" and on international bridges and related projects, are exempt from wage withholding provided that they "enter and leave the United States at frequent intervals."

The §1441 exemption should probably be construed as clearly applying to self-employed Canadian and Mexican residents who do work of the kind described in Reg. §31.3401(a)(6)-1(c). Thus, a self-employed truck driver would presumably be entitled to a §1441 exemption on the U.S.-source portion of service fees paid to him, although under Article VII (4) of the Canadian income tax treaty an overriding exemption would probably be available anyway.[256] Apart from truck drivers, however, historically it has been unusual for personnel on other kinds of transportation service (railroads, bus, ferry, steamboat, or aircraft) to be self-employed.

In 2016, the IRS stated its position that this exemption includes only Canadian or Mexican residents doing the same kind of work in the transportation service or on international bridges and related projects described in Reg. §31.3401(a)(6)-1(c).[257] Apart from this exemption, in the case of a Canadian resident (other than certain artists and athletes), a separate and overriding exemption from §1441 withholding would be available under the U.S.-Canada Income Tax Treaty if the nonresident alien's U.S.-source income is not attributable to a permanent establishment that the individual has in the United States.[258] A similar exemption would be available under the U.S.-Mexico Income Tax Treaty.[259] Thus, the practical effect of the exemption in the §1441 regulations is probably to grant an exemption from §1441 withholding in those situations where the self-employed Canadian or Mexican resident does, in fact, have a fixed base and/or permanent establishment in the United States, which will deny the individual an exemption from U.S. substantive tax liability under the relevant tax treaty. In addition, the exemption in the regulations would apparently exempt certain Canadian or Mexican artists and athletes from §1441 withholding if they exceed the dollar thresholds in the relevant treaty.[260] However, the §1441 withholding exemption cannot be construed as an exemption from substantive tax liability. In all cases where there is no tax treaty exemption from substantive tax liability, the Canadian or Mexican resident has a substantive tax liability under the Code, probably under §871(b) on the theory that the U.S.-source compensation would be classified as effectively connected with the conduct of a U.S. trade or business.

The regulations do not clarify what documentation a Canadian or Mexican resident must furnish to the payor to claim the withholding exemption. If the withholding exemption is also available under the applicable income tax treaty, presumably the payee would furnish Form 8233 to the payor. If no treaty exemption is available, but the exemption in the regulations is available, the instructions to Form 8233 imply that it may not be the appropriate form.[261] In that situation, Form W-8BEN or Form W-8ECI may be more appropriate, although the payee may need to attach a statement explaining why the payee believes that an exemption from §1441 withholding is available under the regulations.

---

[253] *See* Reg. §1.1461-1(c)(1). *See also* XIII.C.3., below, and 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*.

[254] Reg. §1.1461-1(h) provides that failure to file Form 1042 and/or Form 1042S can result in the imposition of civil penalties under §6651, §6662, §6663, §6721, §6722, and §6723, as applicable.

[255] Reg. §1.1441-4(b)(1) and §1.1441-4(b)(2). *See also* the summary of categories discussed in this section, and in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*.

[256] The U.S.-Mexico Income Tax Treaty does not contain a trucking exemption similar to Article VIII(4) of the U.S.-Canada Income Tax Treaty.

[257] Publication 515.

[258] U.S.-Canada Income Tax Treaty, art. V, art. VII.

[259] U.S.-Mexico Income Tax Treaty, art. V, art. VII, art. XIV. The U.S.-Mexico Income Tax Treaty, unlike the U.S.-Canada Income Tax Treaty, still has a fixed base rule for certain self-employed individuals.

[260] *See* U.S.-Canada Income Tax Treaty, art. XVI ($15,000 limit), U.S.-Mexico Income Tax Treaty, art. 18 ($3,000 limit).

[261] The instructions to Form 8233 state in a "Caution" note on page 1: "Do not use Form 8233 if you have an office in the United States regularly available to you for performing personal services." This language would presumably prevent a self-employed Canadian or Mexican resident who has a U.S. fixed base or permanent establishment from using Form 8233, but perhaps not a Canadian or Mexican artist or athlete who failed the relevant treaty exemption. However, other language in the Form 8233 instructions suggests that the form should only be used by a nonresident alien who earns U.S.-source income from independent personal services, if the individual is either claiming a treaty exemption or rate reduction, or else claiming the daily personal exemption amount (discussed in IX.C.3., above).



ISBN 978-1-61746-986-2

*2. Income Exempt Under the Code or a Treaty*

Reg. §1.1441-4(b)(1)(iv) provides an exemption from §1441 withholding in the case of compensation that "is, or will be, exempt from the income tax imposed by chapter 1 of the Code by reason of a provision of the Internal Revenue Code or a tax treaty to which the United States is a party." The regulations provide further that in order for this exemption to apply in the case of a *treaty* exemption, the nonresident alien claiming the exemption must file a signed statement with the payor of the U.S.-source income on Form 8233.[262] The payor must then file a copy with the IRS shortly thereafter.

It is not clear what form (if any) should be completed by the payee where the exemption from substantive tax liability is available under the Code and not under a tax treaty. The §1441 regulations are silent on this issue, and the issue is not mentioned either in the Form 8233 instructions or in IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.* As discussed below, compliance is probably quite poor within two of these categories (short-term business visitors, and crew members on foreign vessels), and it is not clear whether §1441 even applies to the third category (self-employed operators of foreign vessels and aircraft). To the extent that the payor and/or payee wishes to have documentation in support of the withholding exemption under the Code, however, either Form 8233 or Form W-8BEN can probably be used.

In situations where Form 8233 is required to be used (in other words, if a treaty exemption or rate reduction under §1441 is being claimed), the payor of the remuneration for services must file a copy of the form with the IRS within five days after the payor accepts the withholding certificate submitted to payor by the nonresident alien payee in accordance with Reg. §1.1441-4(b)(2)(iv). If the IRS does not object to the contents of the form within 10 days after it is forwarded by the payor to the IRS, the withholding exemption is proper, retroactive to the date of the first payment covered by the form.[263] If Form W-8BEN or Form W-8ECI is used instead of Form 8233 (for example, in the case of an exemption that is claimed under the Code rather than under a treaty), the form does not have to be filed by the payor with the IRS. In either case, however, the payee must obtain an ITIN and show it on the form.

As indicated in V.B., above, there are four situations under the Code in which nonresident alien *employees* working within the United States are exempt from substantive tax liability and thus also exempt from wage withholding tax:

(1) short-term business visitors who meet the de minimis tests of §861(a)(3);

(2) certain F-visa and J-visa holders;

(3) certain employees of foreign governments, of foreign corporations wholly owned by a foreign government, and of international organizations; and

(4) certain crew members of foreign vessels engaged in international transportation.

An exemption under §861(a)(3) is also available to short-term nonresident alien business visitors who are self-employed as well as to crew members of qualifying foreign flag vessels who are self-employed, but the other two exemptions — F-visa and J-visa holders, and employment by foreign governments and international organizations — are not available to self-employed nonresident aliens. In the case of a self-employed nonresident alien holding an F-visa or J-visa, no income tax exemption is available under §872(b)(3), which applies only to employees. Similarly, self-employed nonresident aliens who perform services in the United States under contract with a foreign government or an international organization are not exempt from tax under §893, which also applies only to employees. In addition, an exemption not available to employees is available to self-employed nonresident aliens who realize income from the operation of foreign ships or aircraft which meet certain tests under §872(b)(1) and §872(b)(2).

The subsections below discuss the following §1441 exemptions which are available under Reg. §1.1441-4(b)(1)(iv) to self-employed nonresident aliens:

(1) the de minimis exception under §861(a)(3);

(2) the exemption for self-employed crew members on a foreign vessel, also under §861(a)(3);

(3) the exemption for self-employed aliens from the international operation of a ship or aircraft, under §872(b)(1) and §872(b)(2); and

(4) the kinds of exemptions generally available under income tax treaties.

*a. De Minimis Exception*

Section 861(a)(3), §864(b)(1), and §871 provide in effect that a self-employed nonresident alien is exempt from tax on compensation for services performed in the United States if three tests are met:

(1) the individual is present in the United States not more than 90 days in the taxable year;

(2) his or her compensation for such services does not exceed $3,000; and

(3) the compensation is received as an employee or under contract with a client or customer who is a foreign person not engaged in a U.S. trade or business, or is the foreign office of a U.S. person.

If any of these tests are not met, the compensation is classified as U.S.-source income and are subject to 30% withholding tax under §1441. As discussed in V.B.1., above, however, with respect to nonresident alien employees who are subject to the same de minimis rules, the extent of compliance with the substantive tax rules by short-term business visitors who are self-employed and withholding as required by §1441 by U.S. or foreign payors is doubtful. Because a self-employed payee would not be an employee under the daily supervision of the payor, a foreign person making payments of less than $3,000 would usually not know whether the recipient would exceed the $3,000 threshold for the year, and one may wonder how often such payors ask for the IRS documentation that the payee may be required to furnish under the §1441 regulations. As discussed above, to the extent that documentation is re-

[262] Reg. §1.1441-4(b)(2).
[263] Reg. §1.1441-4(b)(2)(i).



ISBN 978-1-61746-986-2

quired under the §1441 regulations, it is not clear whether Form W-8BEN or Form 8233 would be more appropriate.

*b. Crew Members of Foreign Vessels*

As discussed in V.B.5., above, §861(a)(3) provides that where a nonresident alien who is temporarily present in the United States as a regular member of the crew of a foreign vessel, the individual's compensation for services performed in the United States is treated as foreign-source income. This exemption appears to be available to a crew member who is self-employed as well as to a crew member who is an employee. As discussed above, to the extent that documentation is required, it is not clear whether Form W-8BEN or Form 8233 would be more appropriate.

*c. Income from the Operation of Ships and Aircraft*

Sections 872(b)(1) and §872(b)(2) provide that self-employed nonresident aliens (including both sole proprietors and partners in a partnership) are exempt from U.S. tax on U.S.-source income attributable to international operation of ships or aircraft if the nonresident alien's country grants an equivalent exemption to individual residents of the United States. Thus, a self-employed nonresident alien who operates a ship or aircraft as a sole proprietorship and who qualifies for this exemption would be exempt from §1441 withholding on U.S.-source compensation for services received by him or her in connection with the shipping or aircraft business, under the rule in the regulations that exempts from §1441 withholding income that is exempt from substantive tax liability under the Code.

Whether or not the nonresident alien satisfies the reciprocal exemption under the Code, it is unclear whether §1441 applies to U.S.-source income from the operation of a ship or aircraft. If the nonresident alien does not satisfy the reciprocal exemption, the U.S.-source profits from operating ships or aircraft are subject to federal income tax either as effectively connected income (taxed at graduated rates) under §871(b), or is subject to a 4% gross tax under §887. In contrast with the effectively connected rules that apply to other types of businesses, however, §887(b)(4) establishes a higher threshold that must be satisfied in order for U.S.-source shipping or aircraft income to be classified as effectively connected income that is taxable at graduated rates under §871(b) (or under §882 in the case of a foreign corporation).[264] As a result, many nonresident aliens and foreign corporations that fail the reciprocal exemption will be taxed under §887 at the rate of 4% of their gross U.S.-source income, rather than on a net basis under §871(b) or §882. Yet there is no withholding mechanism in the Code to collect this 4% tax, and IRS practice seems to be to exempt U.S.-source transportation income from withholding under §1441, although there is no express language in the §1441 regulations in support of this result.[265]

Thus, the §1441 procedures, if any, that apply to a nonresident alien if the Code exemption is available under §872(b)(1) or §872(b)(2) are unclear, as are the procedures (if any) that apply to payors if no Code exemption is available. However, if a Code exemption is available and if the nonresident alien wishes to minimize the possibility that any withholding could be imposed on U.S.-source transportation income, it may be advisable for the alien to furnish either Form 8233 or Form W-8BEN to the payor, with an attachment explaining the factual situation and the law.

*d. Tax Treaty Exemptions*

A variety of tax exemptions may be available to self-employed nonresident aliens who are resident in countries having an income tax treaty with the United States. Depending on the nature of the self-employment, exemptions from U.S. tax are available for U.S.-source income where the individual has no permanent establishment or fixed base in the United States, and under some treaties where the individual spends less than a fixed number of days in the United States during the year or where the individual's U.S.-source compensation is less than a certain dollar maximum. It is important to distinguish the treaty rules that apply to employees, often referred to as "dependent personal services," from the treaty rules that apply to self-employed individuals, often referred to as "independent personal services" in older treaties but more typically covered under the rules on business profits and permanent establishments in more recent treaties. Thus, the very narrow de minimis test of §861(a)(3), discussed in IX.D.2.a., above, is expanded considerably under most tax treaties.

Most income tax treaties also contain broad exemptions for self-employed nonresident aliens engaged in the direct operation of ships and aircraft, and many include exemptions for students, teachers, researchers, and trainees.[266]

As noted above, the §1441 regulations require the treaty country resident to obtain an individual taxpayer identification number (ITIN), or certify that an ITIN has been applied for. One may speculate as to the frequency with which self-employed treaty country residents who are paid by other nonresidents obtain ITINs and comply with this requirement. As indicated above, however, U.S. payors have reason to be more careful than foreign payors in complying with the Form 8233 requirements. As discussed in IX.D.2.e., below, the risk for a U.S. payor who fails to obtain Form 8233 documentation is that the IRS could impose either backup withholding tax under §3406 or §1441 tax on the compensation for services paid to the treaty country alien, at least until such time as the treaty exemption can be proved. If a portion of the compensation for services is foreign-source, moreover, the IRS may impose withholding tax on that portion as well, until such time as the fact that a portion of the compensation is foreign-source can be proven.

*e. IRS Penalties for Failure to Document Section 1441 Exemptions*

If an exemption from §1441 withholding is available under the regulations but the payor fails to obtain timely documentation from the payee in support of the exemption, the payor is liable for the tax that would have been imposed if the exemp-

[264] Section 887(b)(4) in effect requires that the foreign person have a "fixed place of business" in the United States, to which "substantially all" of its U.S.-source transportation income must be attributable.

[265] *See* 6740 T.M., *U.S. Taxation of International Shipping and Air Transport Activities.*

[266] *See* 6400 T.M., *U.S. Income Taxation of Nonresident Alien Individuals*; 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers.*



ISBN 978-1-61746-986-2

tion had not been available — plus interest and penalties.[267] Although the tax itself can be waived if the payor eventually obtains proper documentation from the payee, interest and penalties can nevertheless be imposed on the payor.

Whether this rule increases compliance by *foreign* payors is questionable, however, because the IRS usually has no access to those payors' books and records, and because many of those payors are probably unaware of the §1441 procedures. This rule no doubt operates as an incentive for U.S. payors of U.S.-source compensation for services to nonresident aliens who are treaty-exempt to insist that the payee comply with the Form 8233 procedural requirements, especially because the payments could come to light in the course of an IRS audit of the payor.

Although the principal impact of the penalty effect of Reg. §1.1441-1(b)(7)(i) is in situations involving payments that are treaty-exempt, the regulations probably apply as well to payments that are exempt from §1441 withholding under the Code rather than under a treaty. As noted above, however, in the case of short-term business visitors and crew members on foreign vessels, compliance is probably quite poor because the payments are usually made by foreign payors who may be unaware of the U.S. rules, and enforcement of those rules by the IRS is difficult from a practical standpoint. In the case of nonresident aliens entitled to the §872(b)(1) and §872(b)(2) shipping and aircraft exemptions, it also is not clear whether the §1441 procedures apply at all.

*3. Certain Payments by Ship Suppliers*

Reg. §1.1441-4(b)(1)(v) contains an unusual withholding exemption in the case of a "commission or rebate paid by a ship supplier" to a nonresident alien individual employed by a foreign person in the operation of a foreign-flag ship, where the commission is paid to the recipient for supplies to be used for the operation of the ship. Because such commissions are not exempt from substantive tax liability, the recipient would be required to report such income on a Form 1040NR for the year to the extent that it was U.S.-source income, and to pay any net tax due on such amount. Estimated tax could also be payable during the year. Thus, this exemption is similar to the Reg. §1.1441-4(b)(1)(iii) exemption for certain Canadian and Mexican residents, in that it does not mirror an exemption from substantive tax liability. It is thus distinguishable from the withholding exemptions described in IX.D.2., above, as well as from the exemptions which are available where compensation is otherwise subject to the wage withholding rules of chapter 24 of the Code.

The §1441 exemption for payments by ship suppliers can apparently be traced to Rev. Rul. 58-479, which held that commissions paid by a ship's supplier directly to the ship's master for doing business with the supplier were subject to §1441 withholding if the commission is classified as U.S.-source income. According to the preamble of the Treasury Decision adopting the predecessor of Reg. §1.1441-4(b)(1)(v) in 1979,[268] Treasury-supported legislation was proposed in 1978 to exempt such payments from §1441 withholding. The legislation was not enacted, and instead the Treasury decided to grant the exemption administratively by amending the §1441 regulations. The Preamble makes clear, however, that the §1441 exemption is not intended to eliminate substantive tax liability.

As is true of the §1441 exemption for certain Canadian and Mexican residents (discussed in IX.D.1., above), and for nonresident aliens whose compensation for services is exempt under the Code (discussed in IX.D.2.a. through IX.D.2.c., above), it is not clear from the regulations what documentation (if any) should be provided by the payee to the payor. Because this withholding exemption is similar to the withholding exemption for a Canadian or Mexican resident who does not qualify for a treaty exemption, to the extent that any documentation is required, Form W-8BEN may be more appropriate than Form 8233, probably with an attached statement explaining the facts and citing the exemption in the regulations.

*4. Contractors with Foreign Governments and International Organizations*

Self-employed nonresident aliens who receive U.S.-source service fees from foreign governments and international organizations appear under the literal language of the regulations to be subject to §1441 withholding. As indicated in IX.D.2., above, an exemption from substantive tax liability is not available under §893 or other provisions of the Code for such individuals, although in some cases an income tax treaty exemption may be available which would permit the alien to be exempt from §1441 withholding.

Because international organizations in particular, and to a lesser extent foreign governments, frequently pay consulting fees to self-employed individuals, there are likely numerous nonresident aliens who are technically subject to §1441 withholding to the extent that part or all of their consulting work is done in the United States. Thus, in situations where the individual is subject to substantive tax liability it would appear that a clear §1441 withholding obligation is imposed on the foreign government or international organization. In practice, however, it is extremely doubtful whether the IRS attempts to enforce this withholding obligation. Furthermore, an overriding exemption may be available under the treaty establishing the international organization, under treaties regulating the conduct of foreign relations between the United States and foreign governments, or under uncodified customary international law. Thus, it is assumed that in most if not all cases, a de facto §1441 exemption is probably available to nonresident aliens receiving U.S.-source self-employment income from foreign governments and international organizations.

*5. Reduction in 30% Withholding Rate*

Where a nonresident alien has a high percentage of allowable deductions for expenses incurred in earning self-employment income, Reg. §1.1441-4(b)(3) and §1.1441-4(b)(4) allow the payee and the payor to arrange in advance with the IRS for withholding that is less than 30% of the gross fees paid to the alien.[269] These regulations codify administrative procedures

[267] *See* Reg. §1.1441-1(b)(7)(i). *See* the detailed discussion of this rule in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting.*

[268] T.D. 7582, filed with the *Federal Register* on January 2, 1979.

[269] *See also* IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities.*



ISBN 978-1-61746-986-2

which the IRS has developed over the years primarily for entertainers and athletes.

Under the first of the two alternative procedures in the regulations, the nonresident alien may, prior to receiving any payments, enter into an agreement with the IRS requiring withholding at some amount less than 30%, based on the nonresident alien's projected net income from rendering the services. Under the second alternative procedure, where several payments are expected to be received, the initial payments may be at the normal 30% rate, but before receiving the last payment during the year the nonresident alien may agree with the IRS district office for withholding on that payment in an amount which will result in total withholding on all payments being approximately equal to the nonresident alien's substantive liability for the year on the payments. These two procedures are often used by nonresident alien entertainers who incur significant deductible expenses as part of concerts or other live appearances in the United States.

*6. Filing Requirements for Form 1042 and Form 1042S*

The §1461 regulations require Form 1042 and Form 1042S be filed after the end of the year to report payments which were potentially subject to §1441 withholding but which were exempt from withholding "because of a treaty or Internal Revenue Code exception to taxation."[270] The only exception in the regulations with respect to compensation for services is for "any item required to be reported on a Form W-2."[271]

Thus, if U.S.-source compensation for services is paid to a self-employed nonresident alien and is excluded from gross income under the Code or under an income tax treaty, i.e., if it falls within any of the categories described in IX.D.2., above, Form 1042/1042S reporting is probably required. The only exception might be for compensation paid to a self-employed crew member of a foreign vessel (discussed in IX.D.2.b., above) — for the reason that such fees are classified as foreign-source under §861(a)(3) — and U.S.-source service fees paid to the self-employed nonresident alien operator of a foreign ship or aircraft (discussed in IX.D.2.c., above) — for the reason that such fees may in fact be exempt from §1441 as a matter of IRS administrative practice (although technically they may be subject to the §1441 procedural requirements under the §1441 regulations).

The §1461 regulations do not specifically cover the two remaining categories of compensation for services exempt from §1441 withholding — payments made to certain Canadian and Mexican residents (discussed in IX.D.1., above), and certain payments made by ship suppliers (discussed in IX.D.3., above). These payments are exempt from withholding and are not exempted from withholding "because of a treaty or Internal Revenue Code exception to taxation," but because of an exception in the §1441 regulations themselves. Nevertheless, they may well be included in the general language of the regulations, especially because in both situations they may well be subject to substantive U.S. tax liability in the hands of the nonresident alien recipient. Thus, it may be advisable for the payor to do Form 1042/1042S reporting for these items as well, even though an argument can probably be made that no reporting is required.

Finally, the §1461 regulations do not contain an exception from Form 1042 and Form 1042S reporting with respect to U.S.-source compensation for services paid to a self-employed nonresident alien by a foreign government or international organization. If the regulations do literally require reporting in this situation, however, it is extremely unlikely that the IRS attempts to enforce the reporting rules in this situation.

As noted in IX.C.4., above, civil (and potentially criminal) penalties may be imposed for nonfiling or for late filing of Form 1042 and Form 1042S.[272]

### *E. Estimated Tax Rules*

Under §6654, a self-employed nonresident alien may be subject to penalties for underpayment of estimated tax even though his or her income may have been subject to 30% withholding tax at source. A nonresident alien who makes estimated tax payments uses Form 1040-ES(NR).

### *F. Social Security Tax*

Because self-employed nonresident aliens are exempt from the social security self-employment tax, U.S.-source compensation for services paid to a nonresident alien and subject to §1441 withholding are exempt from social security tax.[273] Because self-employed individuals are not subject to the FICA (the social security tax) tax on employees, no social security tax of any kind is imposed on their self-employment income as a result. If a nonresident alien became classified as a resident alien for federal income tax purposes, the individual would then become subject to the social security self-employment tax and would no longer be subject to §1441 withholding because of the individual's resident alien status. An exhaustive discussion of the self-employment tax on resident and nonresident aliens is found in 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

### *G. Special Categories of Nonresident Aliens*

Special mention should be made of certain categories of payments made to nonresident alien individuals that are potentially subject to §1441 withholding.

*1. Directors' Fees*

Directors' fees are considered by the IRS to be self-employment income and not "wages" received by an employee.[274] Because fees paid for attending board meetings of a U.S. company in the United States would usually be paid by a U.S. company, the de minimis test of §861(a)(3)(C) could not be met and the fees would be subject to 30% withholding under §1441. Many U.S. income tax treaties specifically address directors' fees, providing that income earned by an individual resident of one treaty country for services rendered in the other treaty country in his or her capacity as a director of a company that is

[270] Reg. §1.1461-1(c)(2)(i).

[271] Reg. §1.1461-1(c)(2)(ii)(D).

[272] Reg. §1.1461-1(h) provides that failure to file Form 1042 and Form 1042S can result in the imposition of civil penalties under §6651, §6662, §6663, §6721, §6722, and §6723, as applicable.

[273] §1402(b).

[274] Rev. Rul. 72-86; Rev. Rul. 68-595.



ISBN 978-1-61746-986-2

a resident in the other treaty country may be taxed by that other treaty country.[275] To the extent that a bilateral income tax treaty contains this provision (or, as in the U.S. Canada income tax treaty, does not specifically address directors' fees), the U.S.-source portion of the directors' fees paid to a nonresident alien resident in the other treaty country could be subject to tax, and thus subject to §1441 withholding.

*2. Artists, Entertainers, and Athletes*

U.S. tax treaties generally provide only limited exemptions for self-employed entertainers and athletes from treaty countries. To the extent that no treaty exemption from withholding tax is available, 30% withholding tax would apply under §1441. Because self-employed entertainers often have significant expenses that result in significant overwithholding under §1441, however, the special rules described in Reg. §1.1441-4(b)(3) and §1.1441-4(b)(4), above, are often used by entertainers to reduce their withholding tax to a lower amount that is more likely to approximate the amount of their substantive tax liability under §871(b).

In advising a nonresident alien entertainer or athlete, the practitioner should be familiar with a broad range of IRS enforcement rules, including rules which may ignore the separate existence of a personal service corporation owned by the nonresident alien.[276]

*3. Fellowships of F-Visa, J-Visa, M-Visa, and Q-Visa Aliens*

A complex set of rules applies to nonresident aliens who receive scholarship or fellowship grants that are excludible under §117. Section 1441(b)(2) and the regulations thereunder provide for withholding on the taxable portion of such amounts if received by an F-visa, J-visa, M-visa, or Q-visa nonresident alien. However, such amounts are subject to substantive tax liability as effectively connected income under §871(c), unless the exemption in §872(b)(3) is available. A complete discussion of the applicable rules is contained in 6440 T.M., *U.S. Income Taxation of Foreign Students, Teachers, and Researchers.*

*4. Section 6013(g) and Section 6013(h) Elections*

The §1441 regulations contain specific language dealing with individuals who make a §6013(g) or §6013(h) election. A §6013(h) election would be made where both spouses meet the definition of resident alien on the last day of the taxable year and wish to be resident aliens for the entire year, while a §6013(g) election would be made where one spouse was a nonresident alien for the entire year in the absence of the election (e.g., where one spouse was a resident alien at the end of the year and the other was nonresident alien).

The §1441 regulations provide that if a §6013(g) or §6013(h) election is in effect, the electing individual is nevertheless considered to be a nonresident alien for §1441 withholding tax purposes.[277] This outcome occurs because both provisions provide that the election is effective only for purposes of chapters 1 and 24 of the Code. Since §1441 withholding is imposed under chapter 3 of the Code, a nonresident alien making a §6013(g) or §6013(h) election is still classified as a nonresident alien for §1441 withholding purposes.

### *H. Non-Applicability of FATCA withholding*

As discussed in III.G., above, the FATCA withholding rules under §1471–§1474 do not apply to U.S.-source compensation for services paid directly to a self-employed nonresident alien individual for work done within the United States, because an individual is neither a "foreign financial institution" nor a "non-financial foreign entity" for purposes of §1471 and §1472.

### *I. Remuneration for Services Paid to Foreign Partnerships and Foreign Corporations*

*1. Withholding Under Section 1441 and Section 1442*

As indicated in IX.B.2., above, §1441 withholding is not imposed on compensation for services paid to a foreign partnership that is effectively connected with a U.S. trade or business of the foreign partnership.[278] Similarly, withholding under §1442 — which imposes withholding tax on U.S.-source fixed or determinable annual or periodical income (FDAP) paid to foreign corporations — is not imposed if the item is connected with a U.S. trade or business of the foreign corporation.[279] The regulations provide that a prescribed statement on Form W-8ECI must be furnished to the payor in order for the foreign partnership or foreign corporation to claim exemption from §1441 or §1442 withholding under this exception. However, if the service provider is a partnership, the partnership withholding rules under §1446 should always be considered.

Under the terms of an income tax treaty, U.S.-source compensation for services received by a foreign partnership or corporation that qualified for benefits of a U.S. income tax treaty would usually be classified as business profits under the treaty, which are generally exempt from U.S. income tax in the absence of a U.S. permanent establishment of the foreign recipient. In the case of a foreign corporation, the claim for exemption from §1442 withholding would usually be made on a Form W-8BEN-E. A partnership would furnish Form W-8IMY to the payor as well as the applicable Forms W-8 for its partners.[280]

*2. Potential FATCA Withholding*

A foreign partnership or foreign corporation that realizes U.S.-source income from rendering services within the United States may not be subject to 30% withholding under §1441 or §1442 to which a self-employed nonresident alien individual is generally subject. However, the foreign partnership or foreign

[275] *See* U.S. Model Income Tax Treaty, art. 16.

[276] *See, e.g.*, Rev. Rul. 74-330. Regulations proposed in 2007 would source income of artists and athletes to the location of the event at which the individual performs, even if preparation for the event occurred in a different country. *See* Prop. Reg. §1.861-4(b)(2)(ii)(G), REG-114125-07, 72 Fed. Reg. 58,787 (Oct. 17, 2007).

[277] Reg. §1.1441-1(c)(3)(ii), added by T.D. 9890, 85 Fed. Reg. 192 (Jan. 2, 2020).

[278] The rules on withholding where the foreign recipient is a partnership are contained in Reg. §1.1441-5.

[279] Reg. §1.1441-4(a).

[280] *See* 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting.*



ISBN 978-1-61746-986-2

corporation must comply with the FATCA[281] reporting rules to not be subject to withholding under §1471 or §1472. (As discussed in IX.H., above, a nonresident alien individual is exempt from withholding under FATCA.) Although a discussion of the FATCA rules as they apply to foreign partnerships and foreign corporations that realize U.S.-source income is beyond the scope of this Portfolio, the FATCA rules should be carefully examined by any foreign partnership or foreign corporation that expects to realize U.S.-source income. However, U.S.-source compensation for services would not be subject to withholding under §1471 or §1472 in most cases because they would not constitute "withholdable payments." This is because they would be effectively connected with a U.S. trade or business.[282]

[281] FATCA is part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010, Pub. L. No. 111-147, which added §1471 through §1474 to the Code.

[282] §1473(1)(B).



ISBN 978-1-61746-986-2

## X. Self-Employed U.S. Citizens and Resident Aliens Working Outside the United States

### *A. Interplay of Section 1441, Section 6041, Section 6041A, and Section 3406*

As discussed in III., above, compensation paid to a self-employed individual can be subject to the nonresident alien withholding rules of §1441; to the backup withholding rules that apply under §6041, §6041A, and §3406; or to none of these provisions. Although §1441 withholding applies only to nonresident aliens performing services within the United States, the provisions of §6041 and §6041A (which determine whether the backup withholding rules of §3406 apply) as drafted have a worldwide scope that technically applies to all payors and all payees in the world. However, the regulations under §6041 and §6041A contain territorial limitations that in part attempt to match the withholding and reporting rules of §6041, §6041A, and §3406 to the payee's substantive U.S. income tax liability.

### *B. Rules that Apply to Services Performed Outside the United States*

The regulations under §6041 and §6041A attempt to limit the global scope of both provisions in the case of compensation paid to self-employed individuals (whether U.S. citizens, resident aliens, or nonresident aliens) for services performed outside the United States. Because these regulations are not entirely consistent with one another, before concluding whether compensation for services is reportable, one should review the various regulations that deal with the issue:

1. Reg. §1.6041-3(e) provides an exemption from reporting with respect to "payments representing earned income for services rendered without the United States made to a *citizen of the United States*, if it is reasonable to believe that such amounts will be excluded from gross income under the provisions of section 911 …" (emphasis added). Note that this rule does not apply on its face to resident aliens who may be able to exclude the compensation from gross income under §911. As discussed in VI.B.2., above, this rule is consistent with the absence of a wage withholding exception under §3401(a) for a resident alien working as an *employee* outside the United States and whose wages are likely to be excluded from gross income under §911. With respect to a U.S. citizen whose compensation for services is foreign-source, this regulation does not state what documentation the payor may rely on in order to form a "reasonable belief" that the payment will be excluded from the payee's gross income under §911. Possibly some variation of IRS Form 673, which is used for this purpose by a U.S. citizen working outside the United States as an employee, could be devised by the payor and the payee. Finally, this rule apparently applies whether the payor is a U.S. person or a foreign person.

2. Reg. §1.6041-4(a)(2) provides that reporting is not required under §6041 for payments of foreign-source income that are made and received outside the United States by a non-U.S. payor or non-U.S. middleman. Reg. §1.6049-5(c)(5) defines the terms non-U.S. payor and non-U.S. middleman. Generally, a payor is a person that makes a payment of the type and of the amount subject to reporting under chapter 61 of the Code to any other person during a calendar year, or any person who collects such payments on behalf of another person, or otherwise acts as a middleman. Reg. §1.6049-4(a)(2). A middleman means any person, including a financial institution, a broker, or a nominee, who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee. Reg. §1.6049-4(f)(4). Reg. §1.6049-5(c)(5) excludes from the definitions of non-U.S. payor and non-U.S. middleman U.S. persons (including a foreign branch or office of a U.S. person), the government of the United States or of any state or political subdivision thereof (or any agency or instrumentality of any of the foregoing), a controlled foreign corporation, a foreign partnership that is controlled by U.S. persons, a foreign person the majority of whose income is effectively connected with the conduct of a U.S. trade or business, and a U.S. branch or territory financial institution that is treated as a U.S. person. Reg. §1.6049-4(f)(16) provides circumstances in which an amount is considered to be paid and received outside the United States. In effect, therefore, if a payment is made outside the United States by a payor who is a "non-U.S. payor" (as specially defined), no reporting is required under §6041 by the payor to any payee — whether a U.S. citizen, a resident alien, or a nonresident alien — provided, of course, that the entire payment is foreign-source (i.e., is for services rendered outside the United States). The advantage of this rule is that it does not require the payor to ascertain whether the payment is reasonably likely to be excluded from the gross income of the payee for U.S. income tax purposes. In addition, the rule does not require the payor to obtain any documentation from the payee with respect to the payee's U.S. income tax status, although it does require that all of the services have been performed by the payee outside the United States.

3. Reg. §1.6041A-1(d)(3)(i)(B) contains an exception from reporting under §6041A (which operates in tandem with §6041, which is a much older statutory provision) that is identical to the regulation just described under §6041, i.e., where the payment is made outside the United States by a non-U.S. payor, *and* where the payment is foreign-source income (i.e., the payment is for services rendered outside the United States).

4. Prop. Reg. §1.6041A-1(a)(1) provides that reporting is not required under §6041A "if the service-recipient [i.e., the payor] knows that such amounts are excludable from the gross income of the person performing such services." For this purpose, the payor is entitled to rely on a "written statement" signed by the payee under penalties of perjury, provided that the payor does not have knowledge that the statement is untrue. This rule applies to both U.S. and non-U.S. payors, and is not limited to payees who are U.S. citizens. This rule apparently does not require the payee to provide the payor with an IRS Form W-9 or Form W-8BEN, although presumably such a document would help convince the payor that the accompanying no-gross-income statement was correct.



ISBN 978-1-61746-986-2

5. Prop. Reg. §1.6041A-1(d)(2) excepts from reporting under §6041A any transaction that is exempt from reporting under §6041 by reason of Reg. §1.6041-3.

6. As discussed in IX.B.4., Reg. §1.1441-1(b)(3)(iii)(E) provides that "payments for services" are "presumed" to be made to a nonresident alien if four tests are all met:

(1) the payee is an individual;

(2) the payor does not know, or have reason to know, that the payee is a U.S. citizen or resident alien;

(3) the payor does not know, or have reason to know, that the income is (or may be) effectively connected with the conduct of a trade or business within the United States; *and*

(4) all of the services were performed by the payee outside the United States.

Query whether this rule can be relied upon to exempt reporting under §6041 and §6041A where the payor does not fall within any of the exceptions from reporting that are specifically provided in the regulations under §6041 and §6041A that are described above. As discussed further in XI., below, the regulations under §6041 and §6041A apparently permit a payor to rely on this presumption for backup withholding purposes.

### *C. Summary of the Reporting Rules for U.S. Citizens and Resident Aliens Working Outside the United States*

If a person pays compensation to a self-employed U.S. citizen or resident alien for services rendered outside the United States, the following rules are likely to apply for purposes of §6041 and §6041A, and for purposes of the backup withholding rules of §3406 as well. Before relying on the rules, the payor should be certain that the payee has rendered *all* of the services outside the United States:

— *The person making the payment is a non-U.S. payor within the meaning of Reg. §1.6041-4(a)(2) and Reg. §1.6041A-1(d)(3)(B), and the payment is made outside the United States within the meaning of those regulations.* In this situation no reporting or withholding is required. The payor does not need to obtain any documentation from the payee with respect to the payee's U.S. tax status (whether as a U.S. citizen, a resident alien, or a nonresident alien), nor does the payor need to obtain any certification from the payee that the payment may or may not be excluded from the payee's gross income for U.S. income tax purposes.

— *The payor is a non-U.S. payor, but the payment is not made outside the United States.* In this situation, the payor should probably ask the payee for the written statement described in Prop. Reg. §1.6041A-1(a)(1), to the effect that the payment will be excluded from the payee's gross income for U.S. income tax purposes. (If the payee is a resident alien rather than a U.S. citizen, the payor can probably rely on the payee's written statement, notwithstanding the more narrow language of Reg. §1.6041-3(e), discussed above.) If the payee cannot confirm that the payment will be excluded from gross income under §911 (or under some other Code provision), then the payor should follow the procedures under §3406, i.e., it should request the payee for Form W-9 (or Form W-8BEN if the payee is a nonresident alien), and if a timely form is not received, the payor should do backup withholding under §3406. Note that if the payee certifies that the payment will be included in gross income for U.S. income tax purposes but that it is likely to be fully sheltered by foreign tax credits, that certification is apparently not sufficient to satisfy the regulation. However, if the payee provides the payor with a proper Form W-9, backup withholding should not apply.

— *The payor is a U.S. payor, such as a U.S. corporation.* In this situation the procedures described immediately above should be followed, under Prop. Reg. §1.6041A-1(a)(1). As noted immediately above, if the payee is a resident alien rather than a U.S. citizen, the payor can probably rely on the payee's written statement, notwithstanding the more narrow language of Reg. §1.6041-3(e).

In all three of these situations, it would be advisable for the payor to obtain a certification from the payee that all of the services were rendered by the payee outside the United States. To the extent that any of the services were rendered within the United States, exemption from reporting under §6041 and §6041A will not be available, and the backup withholding procedures of §3406 must be followed.



ISBN 978-1-61746-986-2

## XI. Self-Employed Nonresident Aliens Working Outside the United States

Because self-employment income of a nonresident alien for services rendered entirely outside the United States is exempt from substantive U.S. tax liability under §871, §1441 does not apply and the regulations under §6041 and §6041A provide for an exemption from reporting under §6041 and §6041A (which thus results in an exemption from the backup withholding procedures of §3406). However, the obvious question arises as to what documentation, if any, the payor should request from the payee in order to confirm that the payee is in fact a nonresident alien, and also that all of the services were in fact rendered outside the United States. As discussed in X., above, if the payee is a U.S. citizen or resident alien, or if some of the services were rendered within the United States, then withholding and/or reporting under §1441 or §6041 and §6041A may be required, and possibly the backup withholding procedures of §3406 could apply.

As discussed above, Reg. §1.1441-1(b)(3)(iii)(E) provides that "payments for services" are "presumed" to be made to a nonresident alien if four tests are met:

(1) the payee is an individual;

(2) the payor does not know, or have reason to know, that the payee is a U.S. citizen or resident alien;

(3) the payor does not know, or have reason to know, that the income is (or may be) effectively connected with the conduct of a trade or business within the United States; and

(4) all of the services were performed by the payee outside the United States. Reg. §1.6041-4(a)(1) and Reg. §1.6041A-1(d)(3)(i)(A) in turn provide that these rules can be relied upon so as to be exempt from reporting under §6041 and §6041A, and thus not be subject to compliance with the backup withholding procedures of §3406.[283]

Thus, it is not essential for the payor to receive documentation on Form W-8BEN from the payee, although presumably documentation of this nature will usually assist the payor to satisfy the second test in the regulation (i.e., that the payor "does not know, or have reason to know, that the payee is a U.S. citizen or resident alien").

The presumption in Reg. §1.1441-1(b)(3)(iii)(E) apparently applies whether the payor is a U.S. payor or a non-U.S. payor for purposes of the §6041 and §6041A regulations, and it apparently applies whether or not the payment to the payee is made outside the United States for purposes of those regulations.

---

[283] These regulations cross-reference Reg. §1.6049-5(d)(2)(i), which incorporates the presumption in Reg. §1.1441-1(b)(3)(iii)(E).



ISBN 978-1-61746-986-2

## XII. Special Computational Problems for Employees and Self-Employed Individuals

### *A. In General*

To the extent that a self-employed nonresident alien is subject to withholding tax on U.S.-source compensation for services, the §1441 withholding rules do not attempt to match closely the rate of withholding tax (30%) with the nonresident alien's substantive tax liability, which is computed on a net basis at graduated rates. As discussed in II.C., above, the wage withholding tax rules on employees attempt to match the rate of withholding tax much more closely with the employee's substantive federal income tax liability, but only rarely will the two be identical. In most cases, a discrepancy will occur because the wage withholding system uses a number of "short-cuts" that may result in either underwithholding or overwithholding. In other cases, the disparity may be much greater because the Code may provide for a withholding exemption for remuneration that may nevertheless be taxable to the employee. In the international context, the disparity will often be large, not only because of rules such as that in §3401(a)(8)(A)(ii) (exemption from withholding for remuneration that is subject to foreign wage withholding, regardless of the rate of foreign wage withholding tax), but also because a foreign employer that pays compensation (whether the employee is a U.S. citizen or resident alien working abroad, or an employee working in the United States) will usually not withhold U.S. wage withholding tax even if technically U.S. withholding is required under §3401.

This section discusses in greater detail some of the typical situations in which discrepancies between wage withholding tax and substantive tax liability may occur. The situations discussed below are by no means exhaustive, however, and attention is drawn to other examples contained in the preceding sections. *See also, generally*, 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation.*

### *B. Employee Who Moves Abroad During the Year*

An employee may work in the United States at the beginning of the calendar year but begin working outside the United States at a later time during the year. In many cases the employee's remuneration during the months after his or her move will be partially or completely exempt from U.S. residual tax. As explained in II.C.9., above, however, the wage withholding system does not permit an employee's withholding tax during the early months of the calendar year to be reduced so as to reflect an expected exclusion from gross income for remuneration that the employee expects to earn later in the same year. The reason for this rule seems to be that if the expected move outside the United States does not occur or is shorter than planned, underwithholding during the early months would occur. If the employee does move abroad, however, overwithholding will often occur, and the excess withholding tax would be refunded to the employee only after the employee has filed his or her U.S. tax return for the year.

This situation is likely to occur for two categories of employees. First, employees who move abroad during the year and who are classified as nonresident aliens for U.S. tax purposes after the move, are exempt from U.S. tax on their remuneration for services performed outside the United States after the move. This happens whether they are resident aliens or nonresident aliens while working in the United States prior to the move. Second, U.S. citizens and resident aliens who move abroad during the year and qualify for the §911 exclusion on part or all of their foreign-source earned income after the move, will also be exempt from U.S. tax on the excluded income in the same manner. However, there is no provision on Form W-4 or in the wage withholding regulations for an anticipated exclusion of salary from gross income to be reflected in the level of wage withholding on remuneration that is subject to withholding. Thus, Form W-4 only permits wage withholding tax to be reduced to take into account anticipated deductions or credits that the employee expects to claim on his or her tax return for the year.

Because deductions and credits may be reflected on Form W-4 but not expected exclusions, one possibility for a U.S. citizen or resident alien who expects to move abroad is to furnish Form W-4 to the employer at the beginning of the year reflecting expected foreign tax credits that the employee would claim on the employee's expected foreign earned income for the year based on the assumption that the employee will not elect the §911 exclusion. This method would result in some reduction in wage withholding during the period of the year for which the employee worked in the United States, although often not as much as would occur if the full expected §911 exclusion could be reflected on Form W-4, especially if the employee moves to a low-tax jurisdiction.

### *C. Employee Who Moves to the United States During the Year*

#### *1. Pre-Move Salary Exempt from U.S. Tax*

Overwithholding is just as likely to occur in the reverse of the situation described immediately above in XII.B., where an employee works abroad during the early months of the year with an exemption from U.S. tax, and then moves to the United States and becomes subject to tax during the later months of the year.

This situation may occur in several ways. First, a nonresident alien whose salary before the move was exempt from U.S. tax may become subject to U.S. tax because the employee's salary after the move is U.S.-source and thus is taxable under §871(b). Second, the salary of a U.S. citizen or resident alien prior to the move may be excluded from gross income under §911.

As discussed immediately above, the distinction in the wage withholding system between exclusions on the one hand, and deductions and credits on the other, means that the individuals just described may not adjust their wage withholding on U.S.-source remuneration after the move to reflect the fact that part or all of their remuneration prior to the move was exempt from U.S. tax.

The discussion in II.C.9., above, describes the rules on "part-year employment" in Reg. §31.3402(h)(4)-1(b), whereby an employee in many cases may reduce the amount of wage withholding tax to reflect periods of time during prior pay periods in the year during which the employee was not working in "employment." It would appear that if the employee meets the 245-day test (i.e, that the employee does not expect to work



ISBN 978-1-61746-986-2

in employment subject to wage withholding or substantive tax liability for more than 245 days in the calendar year), the employee should be entitled to have withholding tax computed on an annualized basis with respect to the employee's U.S.-source salary only.

*2. Nonresident Alien Employee Fails Treaty Exemption on Pre-Move Salary*

A common problem for nonresident alien employees who move to the United States relates to situations where the employee works in the United States on visits prior to the move, but during the same calendar year. Under the income tax treaty between the employee's home country and the United States, the employee will typically be exempt from U.S. tax if the employee is on a foreign payroll and if the employee spends less than 183 days during the year in the United States. During the early months of the year it may appear that the employee satisfies the 183-day test, but as a result of the move to the United States the employee spends more time than expected in the United States and fails the 183-day test.

If this situation occurs, the treaty exemption will be lost for all U.S. business days, and the employee will be required to pay U.S. tax for his or her salary on all U.S. business days during the year, including the days during the early part of the year which were originally expected to qualify for the treaty exemption. In this case the employer is not required to make up the wage withholding that would otherwise have been imposed on the earlier salary, if the employer and employee have complied with Reg. §31.3401(a)(6)-1(e) (*see* V.B.6., above). However, the employee will be required to make up the balance of tax due. Assuming that the salary for the previous U.S. business days was subject to withholding tax in the employee's home country, a cash flow problem may develop, because the employee may not have the cash to pay the additional U.S. tax until the employee obtains a refund of home country tax. In any event, in order to avoid estimated tax penalties when the individual files his or her U.S. tax return for the year, the employee may want to request the U.S. employer to withhold additional amounts from the employee's wages (under the "additional withholding" rules discussed in II.C.8., above), or make estimated tax payments on his or her own behalf. The employer may want to consider making a short-term loan to the employee of the necessary funds until the employee can obtain a refund of the overwithheld tax in the home country.

It should be further noted that this problem is not limited to individuals who actually move to the United States, but can also arise in the case of an employee who remains resident in his or her home country but who unexpectedly spends more than 183 days on business trips to, or otherwise working in, the United States during the year. This problem can also occur in the case of individuals who move to the United States from nontreaty countries, and who visit the United States on business trips or otherwise work temporarily in the United States prior to their move. In many cases the individual may have exceeded the §861(a)(3) de minimis test, but the employee's foreign employer will frequently not institute a U.S. withholding system until after the employee moves to the United States. In this case the employee is liable for U.S. tax with respect to the pre-move U.S. business days, and the employer would also remain liable for the withholding tax (plus possible interest and penalties) that should have been imposed on such remuneration.

### *D. Improper Treatment of Particular Remuneration*

If an employee's expected deductions or credits during the year were not foreseen at the beginning of the year, in certain cases the employee may adjust his or her wage withholding tax retroactively so as to prorate the expected tax reduction back over prior pay periods.[284] There may well be situations, however, where withholding that has been effected on particular items of remuneration may have been improper, and as a result a refund of the overwithholding may be made to the employee without the necessity of using the cumulative withholding method of Reg. §31.3402(h)(3)-1.

For example, assume in the case of a nonresident alien whose tax home is abroad that an employer provides an employee with a housing reimbursement and that the employer withholds on it. However, the reimbursement may be exempted from the definition of wages under Reg. §31.3401(a)-1(b)(2) as a direct reimbursement of a bona fide employee business expense under an accountable plan. In that case, presumably the employer may adjust the employee's withholding tax during a subsequent pay period within the same calendar year and refund the excess tax to the employee in accordance with the regulations. A similar situation could occur in the case of a nonresident alien who spends a number of business days outside the United States and whose employer's payroll system cannot track the employee's U.S. and foreign business days on a contemporaneous basis. In this situation, refund of excess withholding tax to the employee in a subsequent pay period within the same calendar year would also seem to be proper. Numerous other situations involving erroneous withholding on particular compensation items that are in fact exempt from wages under §3401(a) can also be imagined in the case of U.S. citizens, resident aliens, and nonresident aliens.

If, however, an employer fails to withhold on a particular item of remuneration that clearly is wages for a particular pay period, the employer would be liable for the undeposited tax, plus possible interest and penalties. In this case, it would be advisable for the employer to deposit the balance of the tax due as soon as the error is discovered.

### *E. Employee Abroad Who Visits the United States on Business*

Where an employee is based abroad but visits the United States frequently on business (or performs business services while visiting the United States for otherwise personal reasons) without qualifying for a tax treaty exemption from U.S. tax, an allocation between U.S.- and foreign-source remuneration will often be required with U.S. tax imposed on the former portion but often not on the latter portion. This situation may arise in the case of a U.S. citizen or resident alien working abroad who is eligible for the §911 exclusion or whose salary is otherwise exempt from U.S. wage withholding. As discussed above in VI.A.7., and in VI.B.7., wage withholding purposes will technically be required in many cases, even though most employers' payroll systems are not designed to track an employee's U.S.

[284] *See* IRS Publication 505, *Tax Withholding and Estimated Tax*.



ISBN 978-1-61746-986-2

and foreign business days from week to week. In this regard, attention is drawn to §3402(e), discussed in II.C.6., above, which provides authority for failure to withhold on the U.S. business days if a majority of the remuneration within the pay period was excluded from the definition of wages because it was for work that qualified for exemption from wage withholding tax. This exemption would seem to exempt many foreign-based employees from wage withholding tax with respect to short business trips to the United States.

As discussed in II.D.4., above, under Reg. §1.861-4(b)(2)(ii)(B), a U.S. citizen or resident alien working full-time outside the United States would be required to source most taxable fringe benefits on a geographical basis (e.g., at the employee's principal place of work), rather than on a time basis. This rule would tend to minimize the portion of the employee's compensation package that was subject to U.S. wage withholding with respect to the employee's U.S. business-related trips.

### *F. Self-Employed Individuals*

The overwithholding and underwithholding issues discussed above with respect to international employees generally do not arise with respect to self-employed individuals who are U.S. citizens or resident aliens, provided that the self-employed individual furnishes the appropriate documentation to the client or customer in order to be exempt from backup withholding, in those situations where such documentation is required. If no backup withholding is required under §3406, the self-employed individual would generally pay any U.S. income tax that was owed on a self-assessed basis. In many situations, the individual would be required to make quarterly estimated tax payments at year-end. In most cases, it should be possible for the self-employed individual to minimize the possibility of making overpayments of estimated tax by following the applicable estimated tax procedures.

In the case of a self-employed nonresident alien who earns U.S.-source income, however, overwithholding would often occur if the alien's customer or client complied with the §1441 withholding procedures. The reason is because the 30% rate of withholding would usually be higher than the effective rate of the alien's substantive tax under §871(b). (As discussed in IX.D.5., however, in some cases it may be possible for the self-employed nonresident alien to work with the IRS so as to reduce or eliminate the overwithholding that would occur if the U.S.-source gross compensation for services were subject to the flat 30% withholding tax under §1441.) Overwithholding could be further exacerbated if the payor, in order to protect itself from the risk of underwithholding, withholds on the portion of the payment that is for services rendered outside the United States and is thus exempt from both withholding tax and substantive tax.



ISBN 978-1-61746-986-2

## XIII. Tax Payment and Filing Procedures

### A. *In General*

The Code requires a number of procedural rules to be followed where remuneration for services is subject to withholding at source. These rules prescribe when and how deposits of tax are to be made and when information on taxes withheld is required to be furnished to the IRS and to the recipient of the remuneration. Penalties may be imposed for late deposit or for failure to deposit withheld taxes, and for nonfiling or late filing of applicable tax forms and returns.

Because of the complexity of the tax payment and return filing rules, this section presents only an overview of the subject. Practitioners seeking guidance on the specific rules should consult the relevant IRS publications, which contain exhaustive information on all relevant rules. These include Circular E (Publication 15) and Publication 505 in the case of wage withholding taxes, and Publication 515 in the case of withholding on service fees paid to nonresident aliens. Additional sources of information include 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*; 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes* (discussion of procedural rules governing social security taxes, most of which also apply for purposes of the wage withholding tax); and 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series).

### B. *Wage Withholding Rules*

#### 1. *Taxpayer Identification Numbers*

Where an individual receives wages and other remuneration subject to §3402 withholding, both the employee and the employer must obtain taxpayer identification numbers.[285] Application for an employer identification number is made on Form SS-4. The employee in most cases is required to obtain a social security number by applying to the Social Security Administration on Form SS-5. If the employee is not a U.S. citizen and without a U.S. visa that permits employment with a U.S. employer, however, the regulations of the Social Security Administration may prohibit the issuance of a social security number.[286]

If the employee cannot obtain a social security number, the employee may nevertheless be required to obtain an "individual taxpayer identification number" (ITIN) if he or she is required to file a federal income tax return.[287] Application for an ITIN is made on IRS Form W-7. Employees who would be required to file a return would include nonresident alien employees who work temporarily in the United States and whose foreign employers do not withhold U.S. wage withholding tax from their salary, but who are nevertheless required to file a U.S. tax return.

#### 2. *Deposit of Withheld Taxes*

Wage withholding taxes generally must be deposited periodically by the employer through an authorized electronic funds transfer system. The frequency of deposits ranges from as often as eight times a month, to as infrequently as quarterly, depending on the aggregate build-up of cumulative withholding taxes in the hands of the employer. Circular E should be consulted on the specific rules.

#### 3. *Forms*

The employer is required to file a quarterly Form 941, *Employer's Quarterly Federal Tax Return*, reporting the total amount of wage withholding tax and FICA withheld during each calendar quarter.[288] Erroneous overwithholding of tax in a prior calendar quarter for the same year may be adjusted on Form 941, provided that an explanatory statement is attached to the return.

An annual Form W-2 is also required to be furnished to all employees whose remuneration was subject to either FICA or to wage withholding.[289] Form W-2 must be furnished to the employee by January 31 after the close of the calendar year, and a duplicate must be filed with the Social Security Administration by February 28. A transmittal Form W-3 must also be filed with the Social Security Administration by February 28.

Where remuneration is exempt from wage withholding, in many cases the law may require a statement to be obtained by the employer from the employee. These rules are discussed in IV., V., and VI. above.

#### 4. *Penalties*

##### a. *Statutory Interest*

Interest at the rate prescribed by §6601 accrues in the case of late deposit of withholding taxes. However, interest ceases to run when the employee makes a voluntary payment of the amount of his or her substantive tax liability, to the extent that the employee's payment covers the amount of withholding tax that the employer should have deposited. In addition, §3402(d) and §6205 provide that in certain situations no interest is charged where the employer inadvertently failed to withhold, but subsequently files a timely supplemental return reporting the underpayment.[290]

---

[285] §6011 and §6109, and the regulations thereunder.

[286] *See* the Worksheets for 6830 T.M., *International Aspects of U.S. Social Security and Unemployment Taxes.*

[287] Reg. §301.6109-1(b)(2). ITINs issued after December 31, 2012 remain in effect until the individual to whom the ITIN is issued does not file a U.S. tax return (or is not included on a U.S. tax return as a dependent) for three consecutive tax years, at which time the ITIN will expire on the last day of the third consecutive tax year of nonuse. *See* §6109(i)(3)(A), added by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §203. ITINs issued before January 1, 2013, on the other hand, have all exceeded their applicable date. *See* §6109(i)(3)(B), §6109(i)(3)(C). Notice 2016-48 provides guidance regarding the implementation of §6109(i), from initial application for an ITIN through request for renewal of an ITIN that has expired due to nonuse and renewal of an ITIN set to expire based on the mandatory expiration schedule. In fact, Notice 2016-48 states that the IRS is implementing a simplified expiration schedule for ITIN holders in recognition of the fact that many may not know when their ITINs were actually issued. Therefore, for administrative simplicity and effectiveness, the IRS will expire ITINs based on the fourth and fifth (middle) digits of the ITIN, rather than the issuance date schedule provided in the Code. The IRS will notify ITIN holders by letter (Letter 5821) and further guidance will be published.

[288] §6011(a).

[289] §6051.

[290] See the discussion in 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation* (U.S. Income Series).



ISBN 978-1-61746-986-2

*b. Late Deposit of Tax*

Failure to deposit withholding taxes on or before the due date exposes the employer to a penalty under §6656(a), unless the late deposit is due to "reasonable cause" or the exception for first-time depositors of employment taxes under §6656(c) applies. Depending on the specific facts, the penalty ranges from 2% up to 15%.

*c. Late Filing of Form 941*

If Form 941, *Employer's Quarterly Federal Tax Return*, is filed late (or is not filed at all), and if there is any liability for undeposited withholding taxes on the due date, the 5% per month penalty of §6651 applies unless the late filing or nonfiling is due to "reasonable cause."[291] The maximum penalty under §6651 is 25%, unless the failure to file is fraudulent. In this case, the penalty is 15% per month, up to a maximum of 75%.[292]

*d. 100% Penalty*

If an employer becomes insolvent and has no assets to satisfy its liability for unpaid withholding taxes, a penalty equal to the amount of the unpaid taxes may be imposed under §6672 on certain officers or employees who were responsible for the failure to deposit the withheld taxes.

*e. Other Penalties*

Other penalties that may be imposed include possible civil penalties for negligence or fraud under §6663; criminal penalties under §7201–§7216; the .5% per month penalty under §6651 for failure to pay taxes shown on Form 941, *Employer's Quarterly Federal Tax Return*; and civil penalties under §6674 for failure to furnish Form W-2 to employees.

## *C. Section 1441 Withholding on Self-Employed Nonresident Aliens*

*1. Taxpayer Identification Numbers*

A self-employed nonresident alien who receives U.S.-source compensation for services usually must obtain an individual tax identification number (ITIN) for one of two reasons. If the individual is subject to 30% withholding tax under §1441 (i.e., not eligible for a tax treaty exemption), he or she is required to show an ITIN on Form W-8BEN. If the individual does not obtain an ITIN and furnish Form W-8BEN to the payor, the payor will withhold either 24% backup withholding tax under §3406 or 30% withholding tax under §1441, depending on the facts and the presumptions in the §1441 regulations. However, if the nonresident alien wishes to file Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and obtain a refund of part or all of the withheld tax on the basis of his or her actual facts, the nonresident alien will need to obtain an ITIN in order to file a proper return.[293]

If instead the nonresident alien claims a treaty exemption from 30% withholding under Reg. §1.1441-4(b)(2), those regulations also require the nonresident alien to obtain an ITIN and to show it on Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, in order to be exempt from §1441 withholding.

The payor may also be required to obtain a taxpayer identification number (TIN) if the payor does not already have one. However, if the payor is a foreign person not engaged in trade or business in the United States there is apparently no requirement that a TIN be obtained, provided that the person also has no U.S. office or place of business; has no U.S. fiscal or paying agent; and has not filed a federal income tax return in his or her own name.[294]

*2. Deposit of Withheld Taxes*

Taxes withheld under §1441 must be deposited at intervals ranging from quarter-monthly to annually, depending on the aggregate dollar build-up of withholding taxes in the hands of the withholding agent. Since 2010, the applicable regulations have required the use of electronic funds transfers for deposits.[295] A detailed discussion of the §1441 deposit rules is contained in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*, and in IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*.

*3. Forms*

In addition to electronic transfers of withheld §1441 taxes, Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, must be furnished to the IRS and to the payee on or before March 15 of the year following that in which the payment is made, together with a transmittal Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, covering all Forms 1042-S for the year. Form 1042-S must be used even if the compensation for services is exempt from withholding under an income tax treaty. A detailed analysis of the rules governing Form 1042-S and Form 1042 is in 6560 T.M., *Payments Directed Outside the United States — Withholding and Reporting*.

*4. Penalties*

Penalties for late deposit (or nonpayment) of §1441 withholding taxes and for late filing (or nonfiling) of Form 1042-S and Form 1042 may also be imposed. These penalties in general are the same as those imposed under the wage withholding system, discussed in XIII.B.4., above. Thus, penalties may include §6601 interest on taxes not timely deposited (up to the date on which the recipient pays such taxes on a voluntary self-assessed basis); the four-tiered late deposit penalty of §6656; the 5% per month penalty for late filing (or non-filing) of Form 1042-S and Form 1042 under §6651; fraud penalties under §6663; and criminal penalties under §7201–§7216.

[291] *See T.L. Squared, Inc. v. United States*, 74-1 USTC ¶9260 (D. Ohio 1974), and *De Franco v. United States*, 56-1 USTC ¶9543 (D. Cal. 1956), in which the §6651 penalty of 5% per month was imposed for late filing of Form 941.

[292] §6651(f).

[293] Reg. §301.6109-1(d)(3).

[294] Reg. §301.6109-1(b)(2).

[295] T.D. 9507, 75 Fed. Reg. 75,897, 75,904 (Dec. 7, 2010).



ISBN 978-1-61746-986-2

### *D. Information Returns Required by Section 6041 and Section 6041A*

#### *1. Taxpayer Identification Numbers*

A taxpayer identification number (TIN) technically should be obtained by both the payor and the payee with respect to remuneration required to be reported on Form 1099-NEC or a supplemental Form W-2. However, there is apparently no requirement that a TIN be obtained if the payor is a foreign person who has no U.S. trade or business, no U.S. office or place of business, and no U.S. fiscal or paying agent, and has not filed a U.S. federal income tax return in his, her, or its own name.[296]

#### *2. Withholding of Tax*

Because §6041 and §6041A only require information be furnished to the IRS, withholding is not required unless the backup withholding rules of §3406 are applicable.

#### *3. Forms*

Form 1099-NEC (or the supplemental Form W-2) must be furnished to the payee by January 31 of the year following the payment of the service fees, and a duplicate thereof together with a transmittal Form 1096 must be filed with the IRS by February 28.[297]

#### *4. Penalties*

Where §6041 reporting is required but is not done, civil penalties may be imposed under §6721 in the absence of reasonable cause (usually in the amount of $250 per late or incorrect return.

It should be noted that even though the payor has obtained proper documentation from the payee, the payor may still need to file Form 1099-NEC.

[296] Reg. §301.6109-1(b)(2).

[297] Reg. §1.6041-6(a) (the deadline is March 31, if filed electronically). *See* T.D. 9892, 85 Fed. Reg. 5,323 (Jan. 30, 2020).



ISBN 978-1-61746-986-2

# TABLE OF WORKSHEETS



Working Papers for this Portfolio can be found at https://bloombergtax.com.

### *Additional Resources*

- Form SS-4, Application for Employer Identification Number.
- Form SS-5, Application for a Social Security Card.
- Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding.
- IRS Publication 505, *Tax Withholding and Estimated Tax*.
- IRS Publication 919, *How Do I Adjust My Tax Withholding?*





ISBN 978-1-61746-986-2