

Case Study:

Taxation of Personal Services Income Received by Non-US/Foreign Person from the U.S.

This article is the second in the series of articles that discusses foreign-related issues - foreign information reporting, application for ITIN, foreign versus U.S. status, foreign vs. U.S. source income, and myriad foreign issues.

This second part discusses the taxation of personal services income, received by a non-US/foreign person (an entity or an individual), for services performed in the US. For this purpose following is assumed.

- The performer of services is a nonresident alien¹, a foreign corporation² or a foreign partnership³ as referenced under IRC sections 861, 864, 871, 882, 884, 1441, 1442, or 1446, to the extent these code sections are applicable to the taxation of personal services income and/or the tax rates applicable to the same.
- For the sake of simplicity, this article collectively refers foreign partnership, foreign corporation, or a nonresident alien individual as non-US/foreign person, or if the context requires otherwise, specifically as foreign corporation, foreign partnership, or non-US/foreign individual.
- The services are considered performed in the US, sourced in the US, and therefore unless statutory exception or treaty exemption applies, taxed in the US.
- If the services are performed by an individual, this individual is not from Mexico, Canada, or Puerto Rico. (special rules apply to individuals from these countries).
- The performance of personal services does not include pay for teaching, scholarships and fellowship grants, or payment under exchange or training programs, or other grants, prizes and awards (a somewhat similar but a separate set of rules apply to these).

¹ IRC Sec. 7701(b)(1)(B) Individuals who are not US citizens and who do not meet either the green card test or the substantial presence test for resident alien status are considered nonresident aliens.

² IRC Sec. 7701(a)(4) and (5). A foreign corporation is a corporation that is neither created nor organized in the US or under the law of the US or of any State. Special

The reason for these assumptions is that many of these are topics by themselves that require a more comprehensive analysis. In another part of this series I may discuss these topics separately.

When reviewing taxability of income from performance of personal services in the US by a non-US/foreign person, the questions to review include:

- Who is performing these services?
 - An individual, or an entity?
- If an entity is performing these services
 - Is it a partnership, or a corporation, or a disregarded entity?
 - Is the performance of services characterized as a US effectively connected taxable income (USECTI) or is it a non-effectively connected income?
- If an individual is performing these services,
 - Is this performance as an employee or as an independent contractor?
 - Is the performance of services in the course of a trade or business of this individual?
 - What is the visa status of this individual?
 - How long is the individual in the US for this purpose?
 - What is the amount of compensation received?
 - Is there a tax treaty that changes the applicable tax?

First the general rules. The income from the performance of personal services is taxed in the jurisdiction where it is considered sourced. The place of payment, the place of residence of the payer, or the place where the contract to perform such services is entered is irrelevant for this purpose. As such only if the services are performed by a non-US/foreign person, in the US, that it is considered sourced in the US⁴. A de minimis exception to this general rule provides that the performance of services is not considered US source if, (1) the services are performed by a non-US/foreign person who is

definition applies to corporation created or organized in Guam, American Samoa, the Northern Mariana Islands, or the Virgin Islands or under the law of any of those US possessions.

³ IRC Sec. 7701(a)(4) and (5). Broadly speaking, a foreign partnership is a partnership that is neither created nor organized in the US or under the law of the

present in the US for a period that does not exceed 90 days during the tax year, (2) with the total pay not exceeding \$3,000, and (3) the performance of services is under a contract with (a) a nonresident alien individual, foreign partnership, or foreign corporation, neither of whom are engaged in a trade or business in the United States; or (b) a U.S. citizen or resident alien individual, a domestic partnership, or a domestic corporation, if the labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by this individual, partnership, or corporation⁵. Note that even if each of the conditions set out in the preceding paragraph are satisfied but if the total pay is more than \$3,000, the total amount paid is considered income from sourced in the US.

Once it is ascertained that the performance of personal services by the non-US/foreign person is sourced to the US, the answers to the questions in the preceding paragraph are crucial to the determination of,

- the applicable US tax rate, that is 30%, or a graduated tax rate, or a reduced rate/no tax under an applicable tax treaty,
- the time at which this tax becomes payable and who pays this tax, that is thru the payments of quarterly estimates by the non-US/foreign person, or thru withholdings by the payer, and/or upon filing of the tax return by the non-US/foreign person, and
- the amount subject to tax, that is net income after all allowable deductions or gross income without any deductions.

Let us begin. In general, when we talk about the payment for performance of personal services, we think of an individual working as an employee or as an independent contractor. However, personal services can be performed by a foreign partnership or a foreign corporation. A clear understanding of who - an individual or an entity - is performing services is necessary to decide who pays the tax, how, and how much.

US or of any State, unless the Secretary provides otherwise by regulations. Under certain circumstances a domestic partnership may be treated as foreign. This article is not intended to review these complex situations.

⁴ IRC Section 861(a)(3)

⁵ IRC Section 861(a)(3)

employees, has a US subsidiary or other associated entity in the US, or nexus is created in a State in the course of performance of services, or is considered a controlled foreign corporation. In addition the foreign corporation may be subject to a 30% branch profits tax on the after-tax earnings of the corporation's US trade or business if certain conditions are met¹³. In conclusion, when an entity is providing personal services additional analysis is necessary.

3. **Performance of Personal Services By a foreign partnership:** Similar to a foreign corporation, generally one is not likely to view a partnership as providing personal services but view it as being in a trade or business in the US¹⁴ and receiving US effectively connected taxable income ("USECTI"). Broadly speaking, the factors to consider in determining if an item of income is treated as an effectively connected or not include (a) whether the income is from assets used in, or held for use in, the conduct of the trade or business, or (b) whether the activities of that trade or business were a material factor in the realization of the income¹⁵.

Normally it will be a bit odd for a foreign partnership to directly (as opposed to through another US partnership or US corporation that it owns) provide personal services in the US. If, however the foreign partnership provides personal services directly, the discussion will be the same as above under "*Performance of Services By a foreign corporation*".

There is another unique wrinkle however with respect to foreign partnerships that have non-US/foreign persons as partners (as opposed US persons). Under section 1446, a partnership, with US effectively connected taxable income is required to withhold tax, at the highest marginal tax rate applicable to the individuals, on the distributive share of the ultimate individual foreign partner's partnership income. The

¹³ IRC Section 884.

¹⁴ IRC Reg. Sec. 1.864-2(b)(1) The term engaged in trade or business in the US does not include performance of personal services (i) for a nonresident individual, foreign partnership, foreign corporation, not engaged in trade or business within the US at any time during the taxable year, or (ii) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the US or by a domestic partnership, or a domestic corporation, by a nonresident individual who is temporarily present in the US for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of \$3,000.

¹⁵ IRC Section 864(c)(2)

if, however, the foreign corporation is considered not receiving a USECTI", or meets each of the following, the payor must withhold 30% of the gross payment of the personal service income. These conditions include:

- The foreign corporation qualifies as a personal holding corporation for income tax purposes¹¹.
- The foreign corporation receives amounts under a contract for personal services of an individual whom the corporation has no right to designate.
- 25% or more in value of the outstanding stock of the foreign corporation at some time during the tax year is owned, directly or indirectly, by or for an individual who has performed, is to perform, or may be designated as the one to perform, the services called for under the contract¹².

If taxed at 30%, this rate applies to the gross amount. No deduction is allowed. The payor reports and remits the 30% tax to the IRS using Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons).

Additionally, Form 1042-S (Foreign Person's U.S Source Income Subject to Withholding), is filed by the payor, with the IRS and a copy provided to the foreign corporation.

Whatever be the tax rate, 30% or graduated, the applicable tax treaty may reduce the applicable tax rate or exempt the personal services income from any US tax. Some of these treaty related matters are discussed in greater depth below under Item 3 (Performance of Personal Services by an Individual).

This indeed is a highly simplistic view of the taxation of income of a foreign corporation from the performance of personal services. More complex analysis may be necessary, for example if the foreign corporation has US offices or

¹⁰ See instructions to Form W08ECI - Who must provide Form W-8ECI

¹¹ A personal holding company is the one that meets both the income and the stock ownership tests. (1) The income test is met if at least 60% of the corporation's adjusted ordinary gross income for tax year after certain adjustments consists of dividends, interest, rent, royalties, annuities, amounts received from personal services contract, and income from estates and trusts. (2) The stock ownership test is met if at any time during the last half of the tax year of the corporation, 50% in value of the corporation's outstanding stock is held directly or indirectly by 5 or fewer individuals. IRC Sections 541, 542, and 544.

¹² IRC Section 543(a)(7)

1. **Performance of Services By a foreign corporation:** Generally, one is not likely to view an entity as providing personal services but view it as being in a trade or business in the US⁷ and as such receiving a US effectively connected taxable income (USECTI). Broadly speaking, the factors to consider in determining if an item of income is treated as an effectively connected or not include (a) whether the income is from assets used in, or held for use in, the conduct of the trade or business, or (b) whether the activities of that trade or business were a material factor in the realization of the income⁸.

2. If the income of the foreign corporation is USECTI it is taxed at a graduated rate applicable to corporations⁹. The foreign corporation will file the tax return for its tax year and pay the tax in the US on a net basis (that is after deduction of all allowable expenses under the US tax code)⁹. The foreign corporation may need to make estimated tax payments under normal rules applicable to the US corporations. In order to prevent the payor from withholding at 30% on this income, the foreign corporation must provide Form W-8ECI (Certificate of Foreign Person's Claim that Income is Effectively Connected With the Conduct of a Trade or Business in the United States) to the payor. If, however the foreign corporation is claiming exemption from any withholding due to treaty provision, the payor is not provided a Form W-8ECI but a Form 8233 (Exemption from Withholding on Compensation for Independent (and Certain Dependent)¹⁰ is provided instead. Once the necessary form is received, the payer of the personal services income has no obligation to withhold any tax from the payment due to the foreign corporation.

⁶ IRC Reg. Sec. 1.864-2(b)(1) The term engaged in trade or business in the US does not include performance of personal services (i) for a nonresident individual, foreign partnership, foreign corporation, not engaged in trade or business within the US at any time during the taxable year, or (ii) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the US or by a domestic partnership, or a domestic corporation, by a nonresident individual who is temporarily present in the US for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of \$3,000.

⁷ IRC Section 864(c)(2)

⁸ IRC Section 882(a)

⁹ IRC Section 882

tax is remitted by the partnership to the IRS using Forms 8804 and 8805. If the aggregate section 1446 tax on the US ECTI is \$500 or more, the partnership is required to make estimated tax payments due by 15th day of the 4th, 6th, 9th, and 12th months of the partnership's tax year. A copy of the Form 8805 is provided to the foreign partner. The foreign partner can then file his/her personal tax return in the US to seek refund of tax that is more than his/her marginal tax rate¹⁶. A foreign partner is not likely to have a taxpayer identification number to enable him/her to file a tax return in the US. The foreign partner must in that case apply for an ITIN using Form W-7, contemporaneous with the filing of his/her tax return on Form 1040NR. The tax withheld by the partnership is considered distribution by the partnership to the partner¹⁷.

Once again, this too is a highly simplistic view of otherwise a complex situation. A more complex analysis may become necessary if the foreign partnership conducts business through another partnership, or another entity, or nexus is created in a State in the course of the conduct of the business. The review of the nationality of the partners will also be necessary. If the partners are all US residents or US citizens, the above withholding provisions or need to provide W-8ECI may not arise. Instead, a Form W-8 identifying partners as US residents/citizens can obviate the need to make any tax withholding.

4. ***Performance of Personal Services By an Individual:*** The taxability of income for the performance of personal services by an individual is governed by IRC Section 871 and associated withholding provisions are under section 1441. The tax rate and the applicable withholding provisions depend on whether the income is for
- independent personal services, or
 - dependent personal services.

Independent personal services is the term commonly used in the tax treaties. Basically, it is the performance of personal services by a non-US/foreign individual in his/her capacity as an independent contractor as opposed to as an employee. When the performance of personal services is as an employee, it is known as an income from dependent personal services.

Independent personal services income:

The income from the performance of independent personal services by a non-US/foreign individual, unless the tax treaty applies, and unless it is pursuant to a trade or business of the non-US/foreign individual, is taxed at 30%¹⁸ and subject to withholding by the payer under IRC Section 1441. If the income from the performance of independent personal services is considered from a trade or business carried out in the US, it is taxed at a graduated tax rate applicable to individuals¹⁹. The tax is applied to net income after allowing all applicable deductions.

If taxed at 30%, this rate applies to the gross amount. No deduction is allowed. The payor reports and remits the 30% tax to the IRS using Form 1042 (Annual Withholding Tax Return for U.S. Source Income of Foreign Persons).

Additionally, Form 1042-S (Foreign Person's U.S. Source Income Subject to Withholding), is filed by the payor, with the IRS and a copy provided to the non-US/foreign individual. The code 17 is used, on Form 1042-S, to report this income. The non-US/foreign individual is next required to file his/her tax return for the tax year.

If considered trade or business²⁰ and therefore taxed at graduated tax rate, the taxpayer is required to file his/her tax return for the tax year and remit the tax to the IRS. The non-US/foreign individual may be required to make estimated tax payments under normal rules applicable to the US residents/citizens. In order to prevent the payor from

withholding at 30% on this income, the non-US/foreign individual must provide to the payor, a Form W-8ECI (Certificate of Foreign Person's Claim that Income is Effectively Connected With the Conduct of a Trade or Business in the United States). In the event, the non-US/foreign individual is claiming exemption from withholding due to treaty provision, the payor is not provided Form W-8ECI, but the payor is provided Form 8233 (Exemption from Withholding on Compensation for Independent (and Certain Dependent)²¹. Once the necessary form is received, the payor of the personal services income has no obligation to withhold any tax.

Whatever be the tax rate 30% or graduated, under the tax treaty between the US and the country of residence of the non-US/foreign individual, the applicable tax rate may be modified. A careful review of the applicable treaty is necessary before one determines the income subject to tax. This is because each country's tax treaty defines various terms, that permit reduced or no tax, quite differently. Some tax treaties treat the pay for independent personal services performed in the United States as business income and tax the same under the treaty provisions applicable to business profits.

Other tax treaties may exempt the independent personal services income from tax, if the non-US/foreign individual performs the services during a period he/she is temporarily present in the US (typically not more than 183 days), and such person is a resident of the treaty country.

The publication 901 provides a country specific overview of treaty provisions applicable to personal services income. While publication 901 is a good start to understand the applicability of the treaty to a given situation, it is no substitute to reading the relevant provisions of the treaty itself.

¹⁶ Note that special rules apply to the foreign partners of a publicly traded partnership

¹⁷ If the income is considered not US effectively connected 30% tax rate applies to distributive share of the partner's FDAP income. FDAP stands for fixed, determinable and annual periodic payment. Typical examples of FDAP income include interest, dividend, ren, royalty, personal services income, etc. The partnership is required to withhold and remit this tax using Form 1042, 1042-S.

¹⁸ IRC Section 871(a)(1)

¹⁹ IRC Section 871(b)

²⁰ IRC Reg. Sec. 1.864-2(b)(1) The term engaged in trade or business in the US does not include performance of personal services (i) for a nonresident individual foreign partnership, foreign corporation, not engaged in trade or business within the US at any time during the taxable year, or (ii) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the US or by a domestic partnership, or a

domestic corporation, by a nonresident individual who is temporarily present in the US for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate gross amount of \$3,000.

²¹ See instructions to Form W-8ECI - Who must provide Form W-8ECI

wages to a US person. The non-US/foreign individual performing dependent personal services provides to the employer, a Form W-4 (Employee's Withholding Certificate). The employer/payor reports wages to the employee on Form W-2 and pay/deposit taxes due by filing Form 941 and 940. Essentially the procedure for the payment of dependent personal services income to a non-US/foreign individual is similar to that applicable to the US resident/citizen.

As stated before, the tax treaty of some countries may exempt the wages paid for dependent personal services provided by the non-US/foreign individual in the US. A careful review of the applicable treaty is necessary before the payor may decide to apply reduced tax rate or not withhold any tax. This is because each country's tax treaty defines various terms permitting reduced or no tax quite differently. Under some treaties the pay for dependent personal services is exempt from tax in the US if both the employer and the employee are treaty country residents and the non-US/foreign individual performs the services while temporarily living in the United States (usually for not more than 183 days).

The tax treaties of some other countries provide an exemption if the employer is a resident of any foreign country, the non-US/foreign employee is a resident of the treaty country, and the services are performed while the non-US/foreign employee is temporarily in the US.

The publication 901 provides a country specific overview of treaty provisions applicable to personal services income. While publication 901 is a good start to understand the applicability of the treaty to a given situation, it is no substitute to reading the relevant provisions of the treaty itself.

To avail of the lower tax treaty rate or benefit of a treaty provision, the non-US/foreign individual must provide to the payor, Form 8233 -Exemption from withholding on compensation for independent (and certain dependent) personal services of a nonresident alien individual. While in general the non-US/foreign employee is issued a W-2

evidencing payment of income and withholding, if a treaty provision is invoked, a Form 1042-S (Foreign Person's U.S Source Income Subject to Withholding), is filed by the payor, with the IRS and a copy provided to the non-US/foreign individual. The code 18 is used, on Form 1042-S, to report this income. A W-2 may additionally be issued by the payor if the personal services income is subject to State tax. The non-US/foreign individual is next required to file his/her tax return together with Form 8833 [Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)].

Besides exemption under the applicable tax treaty, the Internal Revenue Code provides limited exemption under which the dependent or independent personal services income of a non-US/foreign individual is either not taxed in the US or is considered not sourced to the US and therefore not taxable in the US. For example,

- The following income is not sourced to the US and therefore not taxable in the US.
 - If the services are performed by a non-US/foreign individual who is present in the US for a period that does not exceed 90 days during the tax year, with the total pay not exceeding \$3,000, and the performance of services under a contract with (a) a nonresident alien individual, foreign partnership, or foreign corporation, neither of whom are engaged in a trade or business in the United States; or (b) a U.S. citizen or resident alien individual, a domestic partnership, or a domestic corporation, if the labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by this individual, partnership, or corporation²². Note that even if each of the conditions set out in the preceding paragraph are satisfied but if the total pay is more than \$3,000, the total amount paid is considered income from sources in the US and is subject to tax at graduated rate or if applicable at the treaty rate.
 - If the labor or services are performed by a non-US/foreign individual in connection with the individual's temporary presence in the US as a regular member of the crew of a foreign vessel engaged in transportation between the US and a foreign country or a possession of the US, the

In order to avail of the lower tax treaty rate or benefit of a treaty provision, the non-US/foreign individual must provide to the payor, Form 8233 [Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual]. The non-US/foreign individual is also required to file (except under some very narrow exceptions), Form 8833 Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), together with his/her tax return.

Despite the available treaty provision, the payor may under certain circumstances withhold at 30% rate because the factors on which the treaty exemption is based may not be determinable until after the close of the tax year or at the time the payment is being made. For example, if at the time of payment of the personal services income, the parties are uncertain as to the term of the contract - less than or more than 183 days. The payor may withhold 30% despite the exemption/reduced rate claimed by the non-US/foreign individual. The non-US/foreign individual can recover the over withheld tax upon filing his tax return.

The above discussion related to the independent personal services income may become irrelevant if the final payment exemption under IRC Reg, Sec. 1.1441-4(b) applies. Subject to the approval from the IRS, meeting certain procedural requirements, and if the amount of the payment sought to be exempt from withholding is not more than \$5,000, the final or the last payment of compensation for personal services income may be exempt from withholding provisions of section 1441, either totally or partially.

Dependent personal services income:

The examples of dependent personal services income include salaries, wages, bonuses, or any other pay for personal services ("wages"). Subject to certain treaty exemptions or statutory exceptions, such income is subject to withholding at a graduated tax rate applicable to individuals and not at the 30% withholding rate. The tax is withheld by the employer, each pay period, in a manner that is similar to the withholding on the payment of

²² IRC Section 861(a)(3)

compensation for such labor or service is deemed non-US source and therefore not taxable in the US²³.

- The following income is exempted from US tax:
 - The compensation paid to “F”, “J”, or “Q” visa holders, by a foreign employer, for the period these visa holders are temporarily present in the US, is exempt from US income tax²⁴. Typically, these visa holders comprise of students, scholars, trainees, teachers, researchers, research assistants, professors, specialists or leaders in specialized knowledge fields.
 - The compensation for personal services paid to certain residents of Mexico, Canada, or Puerto Rico may also not be subject to US tax. As mentioned earlier, there are many nuances to this exception and is not discussed here further.

5. **By a Disregarded Entity:** If services are performed by a disregarded entity, a further analysis as to the location (US or foreign) and status (corporation, partnership, or an individual) of the 100% owner needs to be looked at first. Depending on these findings any or none of the discussion may become applicable and a further analysis is necessary.

Finally, the taxation, reporting, and withholding of US source personal services income payable to a non-US/foreign person spans over a complex web of rules involving several code sections, review of treaty provisions of the country where the service provider is the resident as well as an if and then analysis of various factors. When we add to this mix (a) the nature of the services provided, that is as a teacher, or as a student, or as a researcher, (b) the visa status of the individual in the US, (c) the length of intended stay versus the length of the actual stay, and (b) the type of payment received, that is, pure wages, payment to a permanent establishment in the US, or scholarship, grant, award, or prize, or winning, the things get complicated very quickly. While many factors in seeking services from a foreigner may not be in the hands of the receiver of the personal services, in order to derive the best tax situation (for the receiver and the performer of the personal services) it is essential that the rules related to taxation of personal services income are not only

reviewed carefully but compiled with quite carefully. The non-withholding of required tax, or non-filing of the required tax form to report the income and the tax withheld, are quite hefty, ranging from few hundred to a few thousand dollars depending on the type of violation.

About the Author: Ragini Subramanian is a Tax & Business Services manager in Marcum LLP's Greenwich, CT, office. She is New York attorney and EA with an LL.M. in Taxation from Boston University. She can be reached at ragini.subramanian@marcumllp.com.

Marcum LLP (www.marcumllp.com) is a national accounting and advisory services firm with offices in major business markets throughout the U.S., as well as Grand Cayman, China, and Ireland.

²³ IRC Section 861(a)(3)

²⁴ IRC Section 872(b)(3)