US Tax Issues for Foreign Partners: US Withholding Taxes & Tax Treaties

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US Withholding Tax – In General

- Mechanism for collecting US tax on mobile income paid to foreign persons:
  - Burden imposed on payor of income; and
  - Payor may be US or foreign.
- May be reduced or eliminated by treaty.
- Significant penalties imposed on payer for failure to withhold.

5 Types of US Withholding

- US source services income
- Foreign partner's share of US-connected partnership income
  - US partnerships treated differently than foreign partnerships
- FATCA [IRC Chapter 4 withholding]
- US source fixed determinable annual or periodic (FDAP) income [IRC Chapter 3 withholding]
- FIRPTA withholding on disposition of US real property interest

Services Income Withholding

- U.S. source income only taxed in the US:
  - Source based on place of performance
- If paid to foreign corporation or foreign partnership:
  - Generally, no withholding because it is effectively connected income (ECI)
    - IRC §§ 1442(a), 1441(c)(1)
- If paid to nonresident alien individual:
  - Independent contractor
    - IRC § 1441 FDAP withholding
  - Employee
    - IRC § 3401 Employee withholding

Foreign Partner Withholding by US Partnership

- *Distributive* share of US partnership's:
  - US source FDAP income
    - 30% withholding unless reduced or eliminated by a treaty
      - Reg. § 1.1441-3(f)
  - Income effectively connected to the conduct of a trade or business within the US (ECI)
    - Withholding at highest IRC §1 or §11 rate in effect for year
      - Nonresident alien individual partners – 39.6% in 2015
      - Foreign corporation partners - 35% in 2015
        - IRC § 1446; Reg. §§ 1.1446-1 to 1.1446-7
- *Actual distribution* of US source FDAP income:
  - 30% withholding unless reduced or eliminated by a treaty
    - Reg. § 1.1441-3(f)

Foreign Partner Withholding by Foreign Partnership

- Foreign partnership required to withhold only on foreign partners share of ECI, not FDAP income.
  - IRC § 1446; Reg. §§ 1.1446-1 to 1.1446-7
- US tax is withheld at highest IRC §1 or §11 rate in effect for year.
  - Nonresident alien individual partners – 39.6% in 2015
  - Foreign corporation partners - 35% in 2015

FATCA [Chapter 4] Withholding

- Payer of “withholdable payment” must withhold 30% from such amount paid to a non-U.S. payee UNLESS payee agrees to provide information with respect to its U.S. customers or owners.
  - Withholdable payment = U.S. source FDAP income or gross proceeds related to U.S. source FDAP securities.
- Chapter 4 withholding applied BEFORE Chapter 3 withholding.

IRC §§ 1471-1474

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US Source FDAP Income [Chapter 3] Withholding

- Withholding tax imposed on US source FDAPI.
  - IRC §§ 1441 & 1442
- US withholding at 30% rate unless payor receives appropriate Form W-8 claiming entitlement to reduction in or exemption from US withholding tax.
  - Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals);
  - Form W-8BEN-E, Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities);
  - 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;
  - Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding and Reporting; and
  - Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting.

FIRPTA Withholding

- Triggered in connection with the disposition of a US real property interest (USRPI) by a foreign person.
- Buyer (US or foreign) must withhold 10% of foreign seller's amount realized in connection with a disposition of USRPI.
  - Amount realized = gross proceeds + liabilities assumed
    - IRC § 1445(a)
- Special rules for distributions of USRPIs by entities.
- A partnership interest will be considered a USRPI if (1) 50 percent or more of the value of the partnership's gross assets consists of U.S. real property interests, and (2) 90 percent or more of the value of the partnership's gross assets consists of U.S. real property plus cash or assets readily convertible into cash.

Use of Income Tax Treaties by Foreign Partners

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Income Tax Treaties

- Bi-lateral agreements between 2 governments.
- Promote trade and investment by dividing taxing jurisdiction between the 2 countries to lessen incidence of double taxation.
- US has treaties with a number of (but not all) foreign countries.
- Each US treaty has different provisions, though they are similarly structured.

Impact of Treaties on Foreign Partners

- If applicable, an income tax treaty may reduce eliminate US federal income tax otherwise imposed on a foreign partner.
  - N/A to state tax
- Savings clause – generally prevents treaty from reducing US taxes of US partners.

Key Treaty Concepts

- Resident;
- Substantive Tax Provisions
  - Business Profits/Permanent Establishment
  - Dividends, Interest, Rents, Royalties
  - Other Income
- Limitation on Benefits
- Competent Authority
- US Domestic Law Limitations

Treaty Residency

- Only individuals and entities that fit within the treaty definition of “resident” can claim the benefits of a treaty.
- Definitions of “resident” vary by treaty.
- Nearly all US treaties have a tie-breaker rule for those situations where an individual or entity is considered to be a resident of BOTH treaty countries.

Business Profits/Permanent Establishment

- To be taxable in the US, treaties provide that "business profits" of a foreign partner must be attributable to a "permanent establishment" ("PE") in the US.
  - "Business profits"
    - Includes foreign partner's share of partnership's ECI
    - Determined on a net basis
  - "PE"
    - Generally means an office or other fixed place of business of partnership (or partner) in the US
    - Can include dependent agents and employees even if they do not work at a fixed place of business
    - Certain preliminary and auxiliary activities can be exempted from the definition

Dividends, Interest, Rents and Royalties

- Nearly all treaties contain separate articles dealing with the taxation and rates of tax on various types of passive income, including dividends, interest, rents and royalties.
- Rates and exemptions vary by treaty.

Other Income

- Many treaties contain an “Other Income” article.
- Specifies how income that is not covered by another specific article of the treaty is taxed.
  - Frequently will result in taxation of “other income” by only country of residence.
  - Some treaties tax “other income” based on where income arises.

Limitation on Benefits

- Designed to prevent treaty-shopping. Contained in nearly all US treaties.
- Typical modern LOB articles limit treaty benefits to the following qualifying persons that are resident in a Contracting State:
  - Individuals;
  - Contracting States or their political subdivisions or local authorities;
  - Tax-exempt organizations and pension funds;
  - Publicly traded companies and certain subsidiaries;
  - Persons other than individuals satisfying ownership and base erosion tests;
  - Enterprises engaged in an active trade or business in the residence State, if none of the foregoing tests are met; and
  - Persons obtaining a favorable determination from the source-State competent authority , if none of the foregoing tests are met.
- Some treaties include other additional tests:
  - "Derivative benefits" test – third country treaty residents meeting appropriate criteria may count towards meeting the base erosion test; and
  - Income derived from the source State that is connected with, or incidental to, an active trade or business conducted by the enterprise (or, under some treaties, a related person) in the residence State that is substantial in relation to the trade or business activity carried on by the enterprise (or related person) in the source State.

Competent Authority

- If, notwithstanding the provisions of the treaty, a resident on one country will be taxed on the same income by both countries, the Competent Authorities of the two countries can resolve the issue on a taxpayer by taxpayer basis.
- Under the Treaty's Mutual Agreement Procedure, a Taxpayer seeks relief from the Competent Authority of the Contracting State with respect to which he is resident or citizen.

US Domestic Law Limitations on Treaties

- IRC § 7852(d)(1)
- IRC § 894(c)
- Other US Treaty Limitations:
  - Conduit financing regulations; and
  - IRC § 884(e) qualified resident rules.

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IRC § 7852(d)(1)

- Neither a tax treaty nor US domestic law is entitled to preferential status by reason of it being a treaty or law.
- Last enacted rule generally controls:
  - Treaty can override previously enacted legislation; and
  - Subsequently enacted legislation can override existing treaties.

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IRC § 894(c)

- Denies treaty benefits to certain entities that are fiscally transparent for U.S. tax purposes ("hybrid" entities).
  - Applies to item of income derived through a fiscally transparent entity, such as a U.S. partnership, if (1) such item is not treated as an item of income of such foreign person for purposes of the taxation laws of the foreign country; (2) the foreign country does not impose tax on a distribution of such item of income from the fiscally transparent entity to the foreign person; and (3) the relevant treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership.
- Treasury regulations under IRC § 894(c) contain one set of rules for hybrid entities and another for "domestic reverse hybrid entities" (entity that is not fiscally transparent for purposes of U.S. taxation but is fiscally transparent under the tax laws of the residence country of a person holding an interest in the entity).
  - Hybrids - an item of income received by a person (including a single member disregarded entity and excluding individuals), wherever organized, that is fiscally transparent under the laws of the United States (or any other jurisdiction with respect to an item of income) is eligible for a reduced rate of withholding under an applicable U.S. income tax treaty only if the item of income is derived by a resident of the applicable treaty jurisdiction.
  - Reverse hybrids - treaty benefits generally denied with respect to U.S. source income of a "reverse domestic hybrid entity". If certain conditions are met, a payment by a domestic reverse hybrid entity to a related foreign person holding an equity interest in the hybrid is recharacterized as a dividend distribution by the hybrid for all purposes of the Code and applicable treaty to the extent of the lesser of (1) the amount of the payment or (2) the interest holder's proportionate share of dividends distributed by the related domestic entity to the hybrid.

US Procedural Aspect of Treaties

- Foreign partner may need to file various forms with the IRS or withholding agent to claim treaty benefits.
- May need to file US tax return:
  - Form 1040-NR, U.S. Nonresident Alien Income Tax Return
  - Form 1120-F, U.S. Income Tax Return of a Foreign Corporation
- May need to attach Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b) to partner's tax return.
- Provide appropriate Form W-8 to withholding agent.
  - Generally use W-8BEN or -BEN-E, or -IMY when claiming treaty benefits.

Further information

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