



TO: Fiscal Officers of All State Agencies

DATE: September 19, 1995

SUBJECT: Foreign Vendor Reporting and Withholding Requirements

Number: 70

A nonresident alien is an individual who is not a United States citizen or resident. The term includes a nonresident alien fiduciary. A foreign corporation or foreign partnership is one that was not created or organized in the United States, or under the laws of the United States or any of its states. Generally, payments of fixed or determinable annual or periodic U.S. source income to nonresident alien independent contractors, foreign corporations, or foreign partnerships (foreign vendors) are subject to federal and state income tax withholding.

FOREIGN VENDOR PAYMENTS SUBJECT TO WITHHOLDING

Income subject to withholding includes: 1) personal services performed in the United States, 2) rents on properties located in the United States, 3) royalties on properties used in the United States, 4) pension payments where services were performed in the United States, and 5) taxable portions of scholarships and fellowship grants paid by a state agency. The withholding may be exempted or reduced if:

- 1) an alien claims U.S. residence by filing IRS Form 1078, *Certificate of Alien Claiming Residence in the United States*. This statement should be retained by the agency and not forwarded to the Comptroller or the IRS.
- 2) a partnership or corporation supplies a written statement to the agency claiming that they are domestic and not foreign. This statement must contain the entity's employer identification number, the address of its U.S. office or place of business, and the signature of a member of the partnership or the signature and official title of the corporate officer. This statement should be retained by the agency and not forwarded to the Comptroller or the IRS.

- 3) a partnership or corporation supplies the agency with a written statement from the IRS district director stating that the withholding is an administrative burden. This statement should be retained by the agency and not forwarded to the Comptroller or the IRS.
- 4) the income is: a) effectively connected with a trade or business in the United States; b) includible in the recipient's gross income; c) not compensation for personal services performed by an individual and d) a statement claiming exemption, IRS Form 4224, *Exemption From Withholding of Tax on Income Effectively Connected With the Conduct of a Trade or Business in the United States*, has been filed by the person entitled to the income.
- 5) residents of the foreign country are entitled to reduced rates of, or exemption from, tax under a tax treaty between their country of residence and the United States. These foreign residents must notify the paying agency that they are residents of a country with which the United States has an income tax treaty on Form 1001, *Ownership, Exemption, or Reduced Rate Certificate*, or Form 8233, *Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual*. Tables at the end of Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, list countries with which the United States has income tax treaties along with the tax rates that apply to various classes of income.
- 6) the income is U.S. source gross transportation income. See Publication 515 for further information.
- 7) the income is not included in gross income under the Internal Revenue Code.

The Contractual Service Voucher (C-02) is to be used for vouchering payments to foreign vendors which are subject to withholding. See CUSAS Procedure 17.20.55.

RATE OF WITHHOLDING

With certain exceptions, the withholding rate for a nonresident alien is a flat 30 percent unless modified by a tax treaty. The exceptions include wages, pensions, and taxable scholarships and fellowships.

Wages and pensions paid for the personal services of a nonresident alien employee are subject to withholding in the same manner as wages paid to a U.S. citizen (graduated rates); however, most tax treaties provided at least a partial exemption from tax for labor or personal services performed in the United States. The

employee must provide the employer with a statement to claim a treaty exemption from withholding. Details of the statement content can be found in IRS Publication 515.

Compensation for personal services performed by nonresident alien individuals who are independent contractors is generally subject to the flat 30 percent withholding rate, but may be exempt under a tax treaty. Under most tax treaties, compensation for the personal services of nonresident alien independent contractors is exempt only if the services are performed during a period of temporary presence in the United States (usually not more than 183 days) and the nonresident alien is a resident of the treaty country. The compensation is not exempt from U.S. tax if the contractor is a U.S. resident. Independent contractors must file IRS Form 8233, *Exemption From Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual*, to claim a treaty exemption. Form 8233 may also be used to claim a personal exemption (\$2,500 for 1995) reducing the compensation subject to the 30 percent withholding.

Form 8233 must be filed by the alien for each tax year. One copy of the form must be filed with the IRS district director within five days of receipt. One copy should be kept by the agency. One copy should be forwarded to the Contractual Payroll Section of the Office of the Comptroller.

Taxable scholarships and fellowship grants from U.S. sources paid to a nonresident alien with nonimmigrant status are subject to 14 percent withholding.

REPORTING REQUIREMENTS

Generally, Internal Revenue Service (IRS) Forms 1042 and 1042-S must be filed when fixed or determinable annual or periodic income from U.S. sources is paid to a nonresident alien independent contractor, foreign partnership or foreign corporation. The returns must be filed by March 15 following the end of the calendar year of payment. A copy of Form 1042-S must be provided to the payee by March 15. (Forms W-2 and 941 are used to report wages or salaries paid to nonresident alien employees.)

Forms 1042 and 1042-S must be filed even if there was no income tax withholding because of a specific exemption or income tax treaty. The penalty which may be imposed for failure to file Form 1042 when due is usually 5 percent of the unpaid tax for each month or part of a month the return is late, but not more than 25 percent of the unpaid tax.

In order for the Office of the Comptroller to accumulate the necessary data for completion of Forms 1042 and 1042-S, reportable payments to nonresident alien independent contractors, foreign partnerships or foreign corporations (foreign

vendors) must be vouchered on Contractual Service Vouchers (C-02) denoting the appropriate codes for foreign vendor payments. See CUSAS Procedure 17.20.55.

If reportable payments are not vouchered on a Contractual Service Voucher, it is the responsibility of the paying agency to report the payments on IRS Forms 1042 and 1042-S using the agency's federal employer's identification number. Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, should be consulted for complete reporting requirements.

IRS FORMS AND PUBLICATIONS

Reporting Forms

- Form 1042 *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*
Form 1042-S *Foreign Person's U.S. Source Income Subject to Withholding*

Forms used by foreign person to claim exemption from withholding or tax treaty rate

- Form 4224 *Exemption from Withholding of Tax on Income Connected with the U.S.*
Form 8233 *Exemption from Withholding on Compensation for Independent Personal Services of a Nonresident Alien Individual*
Form 1078 *Certificate of Alien Claiming Residence in the U.S.*
Form 1001 *Ownership, Exemption, or Reduced Rate Certificate*

Publications

- Pub. 515 *Withholding of Tax on Nonresident Aliens and Foreign Corporations*
Pub. 519 *U.S. Tax Guide for Aliens*
Circular E *Employer's Tax Guide*

If you have any questions concerning this bulletin, contact Peggy Blackburn, Manager of Accounting Operations Division, (217) 782-4107. This bulletin and other information are available electronically from the Comptroller Bulletin Board System at (217) 785-7678.