

Information Reporting on Form 1042-S, A New Challenge for Accounts Payable

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Reporting income and taxes withheld on payments made to corporate vendors recently became more challenging for accounts payable (A/P) departments of both for-profit and not-for-profit organizations with the new IRS compliance focus on payments to nonresident alien individuals, foreign entities, and foreign governments (collectively “foreign persons”). A/P departments familiar with the ins and outs of Form 1099 reporting now must master not only the long-standing (but long-ignored) withholding requirements for U.S.-source income payments to their vendors who are foreign persons (called “NRA withholding”) but also the requirements for reporting income and taxes withheld, if any, to their foreign vendors and the IRS on Form 1042-S, *Foreign Person’s U.S. Source Income Subject to Withholding*.

Regardless of the name of the form, most U.S.-source income payments made to foreign vendors are subject to Form 1042-S information reporting whether taxes were required to be withheld on the payment or not.² Since only U.S.-source income is reportable, the determination of whether a payment is reportable or not must be made at the transaction level, not at the vendor level as has been the case historically for most payments to U.S. vendors.³ A payer that submits one or more Forms 1042-S must also submit a Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, even if all of the income reported is exempt from withholding either under an Internal Revenue Code or income tax treaty provision. Although the IRS allows multiple submissions of Forms 1042-S, only one Form 1042 may be submitted per employer identification number (EIN).

Form 1042-S information returns must be transmitted to recipients and the IRS no later than March 15⁴, or by the extended date of the form. Paper submissions to the IRS must be accompanied by a Form 1042-T, *Annual Summary and Transmittal of Forms 1042-S*. Payers submitting 250 or more Forms 1042-S (which may be in the aggregate from multiple submissions of original forms) must do so electronically through the IRS’s Filing Information Returns Electronically (FIRE) System.⁵ Form 1042 must also be submitted no later than March 15. A 30-day extension of time to file the IRS copies of Form 1042-S may be requested on Form 8809 (which may be done through the FIRE System without signature). This extension does not extend the time to submit Form 1042. An automatic 6-month extension of time to file (but not to pay taxes) for Form 1042 is requested on Form 7004. There is no specific form for requesting an extension of time to distribute recipient Forms 1042-S.⁶

Information required on Form 1042-S includes the recipient’s name and address, the recipient’s taxpayer identification number, if any,⁷ the amount of gross income, and the taxes withheld (called “NRA withholding”), if any. In addition, payers are required to also record the type of recipient (Recipient Code), type of income (Income Code) and the reason for an exemption from withholding (Exemption Code). The IRS provides with Form 1042-S an Explanation of Codes for recipients defining the codes that their

payers used in completing the forms. The form must also identify the recipient’s country of residence by code (Country Code) as well as by name. The IRS Country Code⁸ list is included in Form 1042-S instructions.

In order to report income and taxes withheld correctly, payers must determine which payments made to foreign vendors are subject to reporting and, if an amount is reportable, record the appropriate Form 1042-S codes as well as the income and taxes withheld. The challenge for payers is providing the appropriate combination of codes on Form 1042-S in accordance with IRS instructions and other guidance provided in IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*. This is not always an easy task.

I. RECIPIENT CODES

In order to report income and taxes properly, payers must generally maintain a record in the name of the income recipient even if payment is made to a different payee.

(a) Payments to Beneficial Owners

Generally, the recipient named on the Form 1042-S is the individual (Code 01) or entity such as a corporation (Code 02) that is the beneficial owner of the income, typically designated on a withholding certificate (W-8BEN, W-8ECI, W-8EXP, or 8233). The beneficial owner of the income is the individual or entity required to record the gross income on their U.S. tax return, were they to have a U.S. tax return obligation. If income is paid to an entity that is disregarded for U.S. tax purposes such as a single-owner disregarded entity, the owner of the disregarded entity is the recipient even though the contract or purchase order may be in the name of the disregarded entity. (A form W-8BEN or W-9 must be in the name of the single owner.)

Sometimes the income is owned by more than one beneficial owner but is directed to be paid to only one of the owners. For example, an entertainment group that is not a legal entity might designate one individual in the group to receive the payment. When there is more than one beneficial owner of the income, as in this case, the income must be reported in the name of each beneficial owner based on an allocation provided by the group or, absent such an allocation, equally.⁹ The determination of whether an income payment is subject to withholding or an exemption from withholding must be based on the attributes and documentation of the individual beneficial owner(s) of the income.

(b) Payments to Third Parties

Occasionally, the beneficial owner of the income will request that the income that they are owed be paid to a third party. Although the payer may make the payment to the third party as requested, under the assignment of income doctrine, the income must still be reported in the name of the beneficial owner. Under this doctrine (defined in case law), a beneficial owner of income may not transfer their tax obligation on that income to another party. For example, if an individual

who performs a service in the United States directs that the payment be made to another party, such as to their corporation or to a charity, the Form 1042-S must still be issued in the name of the individual who is the beneficial owner of the income, with determinations of withholding or exemption from withholding based on the attributes and documentation of the beneficial owner, not the third party.

(c) Payments to Agents and Intermediaries

If income is paid to an agent who acts on behalf of the beneficial owner, the beneficial owner is the recipient, not the agent unless the agent has an agreement with the IRS to take responsibility for NRA withholding and reporting. When income is received by a partnership (Recipient Code 03) or other intermediary that receives the income on behalf of a beneficial owner or owners, such as simple or grantor trusts (Recipient Code 05), the beneficial owners are the generally the recipients (unless an owner is also a flow-through entity).¹⁰ However, if the income is effectively connected to a U.S. trade or business, such as compensation for services performed in the United States by an entity, and the flow-through entity provides a valid Form W-8ECI, the entity is the recipient. The flow-through entity is also the recipient if the entity is a resident of the treaty country for treaty purposes under the applicable treaty's residency article¹¹ and is eligible to claim a reduction of, or exemption from, withholding under a treaty provision on Form W-8BEN.

An intermediary or agent that enters into an agreement with the IRS to accept responsibility for NRA withholding and reporting is the recipient for Form 1042-S purposes. Such responsibility is generally indicated on a Form W-8IMY which may be submitted to the payer by a withholding foreign partnership or withholding foreign trust (Recipient Code 04). In this case reporting and withholding is in the name of the agent or intermediary. Payers making payments to a recipient whose payments are instead covered by a Central Withholding Agreement (CWA) are identified by a letter from the IRS and relieved of Form 1042-S reporting as well as NRA withholding.

(d) Artists and Athletes

The IRS Explanation of Codes includes footnote 2 which states that Recipient Code 09 (artist or athlete) should be used instead of Recipient Code 01 (Individual), Code 02 (Corporation), and Code 03 (Partnership) if the Income Code is 20. Income Code 20 is used for performance earnings of artists and athletes.¹² These terms have been updated in treaties and by the IRS to "entertainers" and "sportsmen" to describe more clearly individuals with performance income.

Footnote 1 of the Explanation of Codes states that compensation that otherwise would be covered by Income Codes 16-19 should be designated as Income Code 20 if "the income is attributable to the recipient's occupation as an artist or athlete." Footnote 2 regarding Recipient Code 09 implies that Income Code 20 should also be assigned to the specified entities if the income of the entity is from the performance of an

entertainer or sportsman. This coding allows the IRS to identify for special scrutiny the income of entertainers and sportsmen paid to corporations and partnerships claiming exemption from withholding. The type of entity with performance income may take other forms, however, such as a complex trust (Form W-8BEN presented) or a tax-exempt organization or private foundation (Form W-8EXP presented) which may in fact be mere agents for a performer or performers. Based on current coding instructions these entities should be identified by their respective Recipient Codes – Code 05 (Trust), 07 (Tax-exempt Organization), and 08 (Private Foundation). It is not clear whether the Income Code for such performance income should be Income Code 20 (and if so, Recipient Code 09?) or Income Code 50 (for lack of a specific code for pay for services to an entity as discussed below).

II. INCOME CODES

As is evident from the assignment of income codes in the two overview tables and the discussions about specific types of income in IRS Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*, Income Codes are used primarily to differentiate reduced rates of tax under income tax treaty provisions. This makes sense from a payer's perspective since gross income not eligible for a tax treaty reduction is either subject to NRA withholding generally at a 30 percent rate¹³ or exempt from tax for a different reason as described by the Exemption Code (discussed below).

Income Codes are also used for two purposes by the recipient: 1) to determine if a tax return is required because of the nature of the payment, and 2) to determine where to record the income on their tax return, if a return is required.¹⁴ The regulations under IRC Section 6012 require that a U.S. tax return be submitted by foreign persons with income effectively connected to a U.S. trade or business (called "ECI") even if the income is exempt from tax under an income tax treaty.¹⁵ ECI is recorded on page 1 of Form 1120-F, or page 1 of Form 1040NR or 1040NR-EZ in the case of individual recipients. Also, nonresident alien individuals, whose only ECI is wages that are less than the amount of one personal exemption under IRC Section 151, are not required to file a tax return if that is their only U.S.-source income for the year.¹⁶ A recipient whose only U.S.-source income is fixed or determinable annual or periodic income (called "FDAPI") on which the correct tax was withheld (including reduced withholding under a tax treaty provision) is not required to submit a U.S. tax return.¹⁷ A return is required if the withheld amount should have been computed at the 30 percent rate but a lower amount was withheld.

Income Codes for records could also be used by information return processors (including the IRS) to verify that Form 1042-S records include a valid tax rate under the applicable treaty indicated by a record's Country Code, a task that would be easier if all records with treaty-exempt income used an Exemption Code indicating treaty-exempt income (discussed below).¹⁸ Income Codes may also be used by foreign tax authorities to identify income being paid to their

tax residents through records received through information exchange under a tax treaty or information exchange agreement.

(a) Nonservices Income

IRS Publication 515, Table 1, *Withholding Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties*,¹⁹ assigns Income Codes to the categories of income described in the table for reduced rates of tax by treaty country.²⁰ Income Codes for some income not included in Table 1 (or Table 2 discussed below) are described in the text. For example, Income Code 50 is used for reporting U.S.-source FDAP not reportable under any other category²¹ such as grants, prizes and awards.

As described below, determining how to report some U.S.-source income payments made by A/P can be particularly problematic. This is the case for three types of income that have not been assigned separate Income Codes: rents on tangible personal property, transportation income, and contingent gains on sales of intangible property.

Rents on Tangible Personal Property. Many older treaties include rents for “scientific, technical, and commercial equipment” in the definition of royalties and generally apply the rate for Industrial Royalties (Income Code 10).²² Presumably, the rents on other types of tangible personal property are covered by the Business Profits Article of these treaties if the income is effectively connected to the conduct of a U.S. trade or business.²³ That the rents are ECI will be identified by Exemption Code 01 on Form 1042-S. Rents on tangible personal property other than on equipment that are not ECI are covered by the Other Income Article (called Miscellaneous Income by some treaties). However, the Other Income Article of most of the older treaties allows the U.S. to tax income not otherwise dealt with by the treaty, and some older treaties have no Other Income Article.

Under most current treaties, equipment rents are not included in the definition of royalties. Rather rents on tangible personal property are covered by the Business Profits Article if they are ECI (or classified as ECI by the Business Profits Article²⁴ or its Treasury explanation²⁵). As ECI, the rents are either subject to tax on a net basis or exempt from tax under the Business Profits Article provided they are not attributable to a permanent establishment that the owner has in the United States. The Income Code for such rents is not discussed in IRS Publication 515. If Table 1 coding is followed, rents that are ECI would be assigned Income Code 10 (Exemption Code 01 if not treaty-exempt and Exemption Code 04 if treaty-exempt). The only other choice is to use Income Code 50 (Other Income) for business profits.

Most treaties that do not include such rents in the Royalties Article allow an exemption from tax under the Other Income Article, provided the income is not effectively connected to a U.S. trade or business,²⁶ in which case the Income Code is 50. However, if Income Code 50 is also used by the payer to report rents on tangible personal property that are exempt from tax

under the Business Profits Article (Exemption Code 04), the forms will not distinguish whether a tax return is required or not.

The obvious dilemma for payers making such rent payments that are not treaty-exempt is which Income Code to assign, Income Code 10 or 50. Until this dilemma is resolved, payers will make inconsistent choices, adding to the confusion of recipients who may (or may not) have a U.S. tax return obligation.

Transportation Income. Multinational organizations make payments to foreign vendors that are international shipping and air freight carriers. Non-profit organizations make occasional payments to such foreign vendors as well. Some of this income may be excluded from income under IRC Section 883,²⁷ some may be exempt from income under either a Business Profits Article²⁸ or Shipping and Air Transport Article²⁹ of an applicable tax treaty, some may be subject to an excise tax rather than income tax (unless it is ECI),³⁰ but some of this income may be subject to NRA withholding such as rents for containers if such rents do not meet the conditions of these exceptions. Until this income is defined and assigned appropriate codes by the IRS, most transportation income will probably be excluded from Form 1042-S reporting (and NRA withholding) by payers whether it should be or not.

Contingent Gains. All treaties except one (the treaty with China, PRC) include in the definition of royalties, gains that are contingent on the productivity, use, or disposition of the property. This is consistent with IRC Section 871(a)(1)(D) and 881(a)(4) which treat such U.S.-source contingent gains as royalties.

It is clear from Table 1 that treaty-exempt contingent gains should be assigned Income Code 10 (Industrial Royalties). However, the proper Income Code for non-treaty exempt contingent gains is less clear because Publication 515 lists them under Gains (Income Code 09).³¹ Assigning Income Code 09 to a contingent gain eligible for a treaty benefit but on which taxes were withheld (because the Form W-8BEN for the treaty claim was not provided or was invalid) will cause a problem for a recipient seeking a tax refund for the treaty exemption on a Form 1040NR or 1120-F tax return. The IRS processors will likely not believe that gross income reported on Form 1042-S as gains (Income Code 09) should be allowed a treaty exemption under the Royalties Article (Income Code 10).

FDAP-Like ECI Payments. The proper Income Code to use when income which is FDAP-like (interest and royalties) is actually ECI also needs to be addressed by Publication 515. For example, the Royalties Article in most treaties states that the reduced rate applies unless the royalty is attributable to a permanent establishment (PE) that the beneficial owner has in the United States. In that case, the income is subject to U.S. tax on a net basis after deductions. The royalty is reported under Exemption Code 01 if it is attributable to a PE and Income Code 04 if it is exempt under a treaty, in this case, as FDAP income. It is not clear which Income Code should be assigned, the FDAP-like

royalty that is ECI, Code 10, 11, or 12 (depending on the type of royalty) or Code 50 because the income is taxed as business profits attributed to a permanent establishment.

Motion Picture and Television Royalties. Payments for the right to use Motion Pictures and Television recordings (Income Code 11) are generally covered under the Royalties Article of treaties. However, a few treaties specifically exclude such payments from the Royalties Article and instead classify the income as part of the business profits of the organization in the Business Profits Article.³² Payers making treaty-exempt payments under one of these treaties must decide which Income Code to use: 11 or 50.

(b) Compensation for Services

IRS Publication 515, Table 2, *Compensation for Personal Services Performed in United States Exempt from Withholding and U.S. Income Tax Under Income Tax Treaties*, assigns Income Codes to the categories of income described in the table and describes the various limitations that apply to each type of income. All of the following Income Codes described in Table 2 are assigned to individual recipients (Recipient Code 01) but see the discussion below about the assignment of Income Code 20 to entities with performance income:

- 15 – Scholarship or fellowship grants
- 16 – Compensation for independent personal services
- 17 – Compensation for dependent personal services
- 18 – Compensation for teaching
- 19 – Compensation during study and training
- 20 – Earnings as an artist or athlete

Although assignment of these codes appears to be straight forward based on their description and discussions in IRS Publication 515, there are some issues that payers must resolve on their own.

Scholarship and Fellowship Grants. Although Table 2 is named “Compensation for Personal Services,” scholarship and fellowship grants reported under Income Code 15 include only scholarships and fellowships for which no services (past, present, or future) are required to be performed in order to receive the grant.³³ Nonresident aliens who are in the United States in F, J, M, or Q immigration status are treated as engaged in a U.S. trade or business, and any scholarship or fellowship grants that they receive are treated as ECI.³⁴ Therefore, such grant recipients are required to submit a Form 1040NR or 1040NR-EZ. The return is required even if the grants are treaty-exempt or do not exceed the personal exemption amount.

Individuals in any other immigration status who are recipients of taxable scholarship or fellowship grants not exempt from tax under a tax treaty are in receipt of FDAPI and have no tax return filing obligation if they have no other ECI and the correct tax has been withheld on the grant. It is not clear whether the Code for a scholarship or fellowship grant in this case should be Code 15 or Code 50 for Other Income.

This same confusion about the proper Income Code (15 or 50) applies to treaty claims for fellowship grants under two Competent Authority Agreements, one

with Austria³⁵ and one with Belgium.³⁶ Under these agreements certain individuals may be able to claim a treaty benefit for fellowship grants for research under the Other Income Article of the treaty if the conditions of the article are otherwise met.³⁷ It is not clear whether the Income Code for a fellowship exempt from tax under the Other Income Article should be 15 or 50.³⁸ Most of the recipients of these grants will be J-1 Research Scholars, and their fellowships, therefore, deemed to be ECI. The agreements do not address how fellowships for these recipients should be recorded on their U.S. tax returns, or whether they have a filing obligation because the treaty exemption is under a FDAPI provision of the treaty.

Types of Services. Compensation for services provided in the United States is ECI (Income Codes 16 through 20) for which a Form 1040NR or 1040NR-EZ tax return is required. The only exception, as mentioned above, is for nonresident aliens whose only ECI is wages not in excess of one personal exemption amount (\$3,650 in 2010).³⁹

Code 16. Income Code 16 applies to compensation of an independent contractor. Recipients report this income on Form 1040NR, Schedule C if taxable or as treaty-exempt income on Form 1040NR if exempt under an applicable tax treaty. The compensation may be exempt either under an Income from Independent Services Article or the Business Profits Article of an applicable treaty. The elimination of a separate article covering self-employment income began with the implementation in 2005 with the new tax treaty with the United Kingdom. The implementation of this change illustrates the confusion encountered by both payers of compensation for independent contractor services and the recipients of such income.

For the first few years, Table 2 of Publication 515 merely footnoted that compensation for independent services was included in the Business Profits Article. Because no treaty article number was included in column 8 of Table 2, Forms 8233 with valid claims for exemption from tax on such compensation were routinely rejected when submitted to the IRS for review as required by the form’s instructions. Some advisors and treatises stated that no exemption from withholding was allowed or, if allowed, had to be claimed on Form W-8BEN rather than Form 8233, even though no change had been made to Form 8233 instructions or the regulations under section 1441 specifying the use of Form 8233 for compensation for personal services of nonresident alien individuals. There was also confusion about the proper Income Code; should it be 16 or 50? The IRS finally settled the matter with publication of the 2009 edition of IRS publication, table 2, which specified article 7 as the Treaty Article Citation (column 8) for Income Code 16 (column 2), Independent Personal Services (column 3) for the following treaties: Belgium, Bulgaria, Canada, Germany, Iceland, Japan, and United Kingdom.⁴⁰

Codes 17, 18 and 19: Income Code 18 applies to compensation for teaching. It also applies to compensation for engaging in research.⁴¹ There is some confusion on this matter because most of the treaties listed in Table 2 do not indicate that Code 18 applies to compensation for engaging in research. In fact, the income tax treaties with all but two countries (Greece and Pakistan) provide for an exemption from tax for engaging in research in the same article as the benefit for teaching.

Code 19 applies to compensation paid for compensation during study or training. Code 18 and 19 could be used for these types of compensation in situations in which the payment is to an independent contractor claiming a benefit under one of the articles with benefits for teaching, engaging in research, studying or training. The treaty language of these articles does not limit the type of compensation (employment or self-employment) covered by the article.

It would avoid confusion if Publication 515 stated clearly that employers and payers should use Codes 18 and 19, not Code 17,⁴² for compensation in these categories even if no treaty benefit is claimed.⁴³ Applying different Income Codes to the same type of income could cause confusion for taxpayers and their return preparers as well. Income Code 17 should be limited to treaty-exempt employment income as defined in Table 2. Ideally, Income Code 18 would be reserved for compensation covered by the Teacher/Researcher articles and Income Code 19 would be reserved for compensation covered by the Student/Trainee articles.

Code 20: Income Code 20 is only used for performance income of artists and athletes (entertainers and sportsmen), but see the discussion about Recipient Code 09 above. When, if ever, Code 20 should be used in other performance situations such as key-man speeches (which can result in very generous honorarium payments) is not clear. Recipients of performance income must also qualify under the treaty article covering compensation paid to independent contractors (self-employment) or compensation for dependent personal services (employment) depending on their relationship to their payer. (Treaty-exempt wages must be reported on Form 1042-S.) Therefore, how these performers should report their income on Form 1040NR, as self-employment or employment income, is not described by the Income Code.

Most tax treaties include an Artists and Athletes Article limiting treaty benefits for residents of the treaty country whose gross receipts exceed the treaty maximum amount. Most treaties include reimbursed expenses in the gross receipts amount even though they may be excluded from income if paid or reimbursed to an independent contractor under an accountable plan.⁴⁴ Forms 1042-S with Income Code 20 may now include Withholding Allowances (box 3) and Net Income (box 4)⁴⁵ which will allow nontaxable

amounts includable in the gross receipts amount to be reported in Gross Income (box 2) but not subject to withholding⁴⁶ or tax on the recipient's Form 1040NR.

(c) Pay for Services Performed by an Entity

Pay for services made to an entity, for the services of its employees and contractors that were provided in the United States, is also considered to be ECI.⁴⁷ The Treasury explanations generally explain that such pay for services is covered by the Business Profits Article. For example, the Treasury explanation of Article 7 of the treaty with Ireland states that paragraph 7 of the article, which defines "profits":

"... states the long-standing U.S. view that income earned by an enterprise from the furnishing of personal services is business profits. Thus, a consulting firm resident in one State whose employees perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7, and not under Article 14 (Independent Personal Services), which applies only to individuals. The salaries of the employees would be subject to the rules of Article 15 (Dependent Personal Services)."

Because the IRS has not assigned an Income Code for pay for services provided by an organization, payers commonly record the payments under Code 50 (Other Income).

When this income is treaty-exempt (Exemption Code 04) under a Business Profits Article, the Form 1042-S is not sufficient to determine whether a tax return is required or not. A return is required for ECI with Income Code 50 but not necessarily FDAPI with Income Code 50. When the compensation is treaty-exempt, the Exemption Code no longer identifies the income as ECI (Exemption Code 01). While larger organizations have sophisticated tax advisors who advise them about their U.S. tax return filing obligations, smaller organizations providing services in the United States may lack such advisors. A separate Income Code for pay for services provided by an entity (or for business profits generally) would be helpful for taxpayers and their advisors.

III. EXEMPTION CODE

Exemption Codes indicate the reason that taxes were not withheld on the gross income being reported. Exemption Codes typically used for payments to foreign vendors are 00, 01, 02, 03, and 04. Code 00 in the Exemption Code field indicates the gross income was subject to NRA withholding. Exemption Code 00 is also used to indicate that the gross income was subject to tax withholding at a reduced rate under an income tax treaty claim (discussed below).

Code 01. In some situations, the Exemption Code also indicates whether the recipient has a U.S. tax return filing obligation. For example, a corporation with income exempt from withholding because the income is effectively connected to a U.S. trade or business (Code 01) has a Form 1120-F filing obligation.⁴⁸ The gross income reported is reduced by allowable deductions and subject to U.S. tax on a net basis.

Code 02. Exemption Code 02 indicates an exemption from tax under an Internal Revenue Code section (except for portfolio income which is indicated by Income Code 05). Exemption Code 02 is also used to indicate income exempt from withholding but not exempt from tax, because there is no current Exemption Code available for this situation. Income exempt from withholding includes U.S. AID per diem amounts paid for subsistence⁴⁹ and forgiveness of indebtedness income in a nonrelated party situation.⁵⁰ Per diem payments are typically small amounts, frequently less than the personal exemption amount, in which case no tax is lost if no tax return is filed. Many organizations dealing with recipients of these amounts are aware that these individuals must submit tax returns and set up programs to ensure that the returns are prepared for the recipients. The recipient of forgiveness of indebtedness income might believe based on the Exemption Code description that the amount is “exempt from tax” and not file a tax return and pay the tax owed.⁵¹ Some of these reported amounts could be significant.

Code 03. The IRS has provided Exemption Code 03 for foreign-source income for payers who wish to use such reporting for internal control purposes. Recipients of income under Exemption Code 03 have no U.S. tax return filing obligation unless the recipient is a U.S. person such as a resident alien individual based on a tax return election. Records with Exemption Code 03 could be included in the information exchange with the recipient’s country of residence where the income might be subject to tax, however.

Code 04. Records reporting treaty-exempt income could have one of two codes: Exemption Code 04, which was only valid if the tax rate was 00.00⁵² or Code 00 indicating the income was subject to withholding (albeit at a reduced treaty rate).⁵³

Whether a foreign vendor with treaty-exempt income has a tax return filing obligation depends on whether the income is ECI or not. As mentioned above, a tax return is due if the income is ECI even if all of the income is exempt under an income tax treaty. No tax return is due for FDAPI on which the correct amount of tax, including reductions under an income tax treaty, has been withheld. As explained above, ECI and FDAPI are not identifiable when the Income Code is 50. This is the case for rents on tangible personal property because of their disparate treatment by tax treaties (described above). Some recipients will have a tax return due because the rents were exempt from tax as business profits (ECI) while others will have no tax return due because the rents were FDAPI subject to a reduced rate, or elimination, of withholding under either a Royalties Article or an Other Income Article of the applicable treaty. This confusion could be resolved⁵⁴ by implementing a different Exemption Code for treaty-exempt ECI.

SUMMARY

Form 1042-S codes describing the type of recipient, type of income reported, and reason for exemption from tax (if any) provide important information for taxpayers and their return preparers as well as the IRS. Some confusion will result from the current code structure when it provides inadequate information for tax return purposes. The expansion of compliance enforcement for NRA withholding to Accounts Payable requires a fresh look at some of these codes and their purposes. The code review and communication process should consider the needs of recipients, who must determine whether they have a tax return obligation, or not as well as the needs of those who make payments to the IRS.

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² Form 1042-S reporting may also include U.S.-source payments made to foreign persons by other corporate departments such as treaty-exempt wages paid by payroll, payments made through intra-company accounting, and financial payments made by treasury. Reporting is not required for foreign-source income payments to foreign persons, but is permissible under Exemption Code 03.

³ This difference in taxation from vendor level to transaction level is one of the reasons that corporations have not been able to quickly adapt their existing processing systems for NRA withholding and Form 1042-S compliance requirements.

⁴ Or next business day if March 15 is a Saturday, Sunday, or holiday.

⁵ See IRS Publication 1187, Specifications for Filing Form 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding, Electronically, for specifications for electronic files and records and Publication 3609, Filing Information Returns Electronically, describing how to use the FIRE System. Payers filing electronically for the first time must request a Transmittal Control Code (TCC) for 1042-S filing on Form 4419. This TCC, which is different from the TCC used for Forms W-2 and 1099, begins with “22.” A first-time waiver of filing electronically may be requested on Form 8508. Refer to Part A, Sec. 12, of Rev. Proc. 2010-38, 2010-38 for information about penalties associated with Form 1042-S filings. This Rev. Proc. is issued as IRS Publication 1187.

⁶ Instructions for such a request are included in IRS Pub.1187 (2010 edition), Part D, Sec. 4, Extension of Time for Recipient Copies of Form 1042-S.

⁷ A U.S. taxpayer identification number is generally required on treaty-exempt income that is not income on publically traded investments. Treaty-exempt income is indicated by Exemption Code 04 if the tax rate is 00.00. Records with a reduced rate under a treaty are recorded under Exemption Code 00 and, as a result are indistinguishable from taxable income by the Exemption Code alone. For the 2010 filing season, the IRS introduced Recipient's U.S. TIN Type 4 to indicate electronic records for which a TIN is required but not available. A TIN is generally also required on other payments made to foreign vendors that are exempt from withholding. Records without a TIN will result in the underwithheld taxes being due with the Form 1042 as well as penalties and interest being assessed.

⁸ Some of these codes differ from the Department of Homeland Security Country Codes used by sophisticated enterprise resource provider (ERP) systems.

⁹ If the names of the beneficial owners are not known, reporting must be in the name of "Unknown Recipient."

¹⁰ An A/P department not in receipt of a Form W-8IMY with a withholding certificate for each owner and an income allocation (a highly likely event) will not be able to report the gross income and taxes withheld in the name of the owners. If the gross income and taxes withheld could be reported in the name of the entity, the flow-through entity could allocate the income and NRA withholding to the owners on a K-1 issued with a U.S. tax return submitted by the entity. This would require changes to the flow-through tax returns but this makes sense since the flow-through entities know who their owners are during the tax year while A/P departments will unlikely receive documentation for ownership changes timely if at all. It would also save A/P departments from around the country from requesting an avalanche of paper from their foreign vendors that are flow-through entities such as overseas service providers which might only occasionally have U.S.-source income (whether FDAP income or ECI).

¹¹ The entity must also meet the conditions of the treaty's residency article.

¹² For an analysis of income derived by professional golf and tennis players, see AM2009-005 (Jul. 2, 2009)

¹³ Payments to individual recipients who are in the United States in F, J, M, or Q immigration status who are candidates for a degree at an educational institution and payments made to such nonimmigrants who are not candidates for a degree by entities defined by IRC Section 1441(b)(2) are subject to NRA withholding at a 14 percent rate.

¹⁴ The IRS does not provide an overview document describing where income reported on the various information returns should be reported on Form 1040NR or 1040NR-EZ as is provided with the instructions for Form 1040.

¹⁵ Treas. Reg. Section 1.6012-1(b)(1) (Nonresident Alien Individuals) and 1.6012-2(g)(1) (Foreign Corporations)

¹⁶ Notice 2005-77 effective for 2006 and subsequent tax years

¹⁷ Treas. Reg. Section 1.6012-1(b)(2) and 1.6012-2(g)(2)

¹⁸ Because many types of income such as interest have many subcategories (defined in the IRS Pub. 515 Table and footnotes) which vary by treaty, it is not possible to determine if the correct rate was withheld as indicated by the treaty claim on a Form W-8BEN, only that a valid rate was withheld for that type of income under the treaty with the country indicated by the Country Code on the form. Income types grouped such as Code 14 (Pensions, annuities, alimony, and/or insurance premiums) would need separate income codes including a code for other types of retirement distributions such as lump sum distributions, individual retirement arrangements (IRAs) and Roth IRAs for an effective automatic analysis of these types of payments since they vary by treaty and may be treated differently under a given income tax treaty.

¹⁹ This table is also included in IRS Pub. 901, U.S. Tax Treaties, although some of the footnotes differ from the Pub. 515, Table 1 footnotes because Pub. 901 is directed toward taxpayers.

²⁰ Although claims for tax treaty exemptions for payments made by A/P departments generally will require that the specific treaty article be identified on line 10 of Form W-8BEN, Table 1 does not (nor can it in its current format) provide the applicable tax treaty article.

²¹ IRS Pub. 515, 2010 edition, p. 27

²² See Table 1, footnote aa

²³ The treaties with two countries (Canada and Sri Lanka) include rents on tangible personal property in the Royalties Article without limiting the benefit to equipment rents only.

²⁴ See for example, Article 8(6) (Business Profits) of the treaty with the Philippines.

²⁵ See for example, the Treasury explanations for Article 7 of the treaty with France and Article 7 of the treaty with the Netherlands.

²⁶ See for example, Article 7(7) of the treaty with Denmark and its Treasury explanation.

²⁷ See TD 9502 (Sep. 18, 2010) for final regulations issued under Section 883.

²⁸ See for example, Article 8(5) (Business Profits) of the treaty with the Republic of Korea.

²⁹ See for example, Article 8 of the 2006 U.S. Model Treaty and Article VII (Transportation) of the treaty with Canada.

³⁰ IRS Pub. 515, p. 27

³¹ IRS Pub. 515, 2010 edition, p.19

³²See for example, Article 7 (Business Profits) and 13 (Royalties) of the treaty with the Netherlands.

³³See IRC 117(b). For a thorough discussion of the tax rules for determining the type of income from grants - taxable grant, employment or self-employment income - see ILM200944072 (July 22, 2009). Note that few nonimmigrants are authorized to engage in self-employment activities by the terms and conditions of their U.S. immigration status unless allowed by an Employment Authorization Document (EAD), by their program, as is the case for certain J-1 exchange visitor programs, or by their immigration status such as P-status athletes and entertainers.

³⁴IRS Section 871(c)

³⁵For a discussion of this Competent Authority Agreement see Singer, "In Search of Guidance on U.S. Taxation of Scholarship Grants For Foreign Nationals," *Tax Analysts, Tax Notes International*, April 18, 2005, p. 273.

³⁶The agreement was signed by the United States Competent Authority on July 7, 2010. The treaty benefits for taxable scholarships and fellowship grants have been systematically removed from existing U.S. income tax treaties as they are replaced by updated treaties, as was the case with the treaty with Belgium. This agreement also states that the term fellowship as used in Article 1(a)(iii) of Article 21 (Students and Trainees) of the prior treaty with Belgium applies to "a Fellowship Payment without regard to whether or not the Fellowship Payment was characterized as compensation." This agreement will allow some fellowship recipients of a "grant, allowance, or award" to amend their tax returns to claim treaty benefits for 2008 (the year that the prior treaty may be elected) that they did not claim on their original return. This statement has no impact on other treaty articles similarly worded, the terms of which are interpreted under IRC Section 117. See Rev. Rul. 80-36, 1980-1 C.B. 391.

³⁷In order to be eligible for benefits under the Other Income Article of a treaty, the grant recipients must have remained tax resident in the treaty country. The grantee must also not be a resident alien under U.S. tax rules described in IRS Section 7701(b) and the regulations under that section, or the resident alien grantee must be able to claim nonresident alien status under the treaty tiebreaker rule in the Article 4(4) Resident. The income must also not be effectively connected to a permanent establishment that the recipient has in the United States. While in most cases, the fellowship income will be ECI because of the immigration status of the recipient (typically J-1 Research Scholar), there was no comment in the agreement about whether a recipient who lives and engages in research in offices and labs in the United States would be considered to have a permanent establishment to which the ECI is attributable.

³⁸Grants by foreign grantors are foreign-source and not subject to tax while the recipient is a nonresident alien. Article 20 of the 2006 U.S. Model Treaty does not include an exemption from tax for U.S.-source scholarship or fellowship grants.

³⁹Nonresident alien recipients of self-employment income reported under Income Code 16 or 20 will have a U.S. tax return filing obligation even if the income does not exceed the personal exemption amount.

⁴⁰This solution was facilitated by the Taxpayer Advocate Service because it involved an unaddressed systemic problem. This Income Code issue was among a number of coding issues and other information return processing and withholding certificate issues that were presented to the IRS and the NTA in a spreadsheet titled, NATRPM Survey of 1042S Concerns, prepared by members of the National Association of Tax Reporting and Payroll Managers (NATRPM). The spreadsheet also identified affected payee and payer populations and proposed solutions. (The membership organization NATRPM is no longer in existence.)

⁴¹Most tax treaties do not allow the benefit if the research is for a private party or parties.

⁴²Income Code 17 is the default income code for all employment from compensation in the PeopleSoft HR/Payroll system.

⁴³Individuals do not claim treaty exemption from withholding for a number of reasons: 1) they are not from a treaty country, 2) they might not have been aware unaware of the possibility of claiming an exemption from withholding, 3) they might have failed to submit the annual Form 8233 for the claim too late to exempt all of their treaty-exempt compensation from withholding, 4) they might be eligible for a treaty exemption but lack the required taxpayer identification number or 4) they might have an employer or payer that declines to provide such treaty exemptions from withholding.

⁴⁴Tax treaties may reduce or eliminate income taxes. They may not create a tax on an income that is not subject to tax under internal law and regulation.

⁴⁵Rev. Proc. 2010-38, p.353

⁴⁶The IRS routinely rejects claims for exemption from withholding claimed by an entertainer or sportsman on Form 8233 if the treaty includes a maximum gross receipts amount because the gross receipts from performing in the tax year (which may include payments by many payers) cannot be known until the end of the tax year. (This situation is addressed by the form's instructions.) A similar rule would apply to the few treaties with a maximum amount in the Independent Personal Services Article. As a result, Form 8233 treaty claims are only allowed for a few treaties - Hungary, Kazakhstan, Poland, and Russia and the nine countries covered by the Former USSR/CIS treaty. A few treaties have an Artists and Athlete Article with no maximum gross receipts amount but the performance must either be through a cultural exchange (China) or funded publically (Morocco and the Ukraine). Artists and Athletes Articles with many treaties include a provision that override the maximum amount if the performance is publically funded or by special arrangement with the governments of the treaty partners. See for example, Article 18 of the U.S./Czech Republic tax treaty.

⁴⁷Rev. Rul. 74-331, 1974-2, C.B. 282

⁴⁸Many unsophisticated foreign vendors focus on exemption from withholding and completely overlook the requirement of filing a tax return which is clearly stated in the note at the top of Form W-8ECI which prompts the reader to “see instructions”

⁴⁹Treas. Reg. Section 1.1441-4(e)

⁵⁰Treas. Reg. Section 1.1441-4(d)(2)

⁵¹A Burden Reduction Submission by the author recommended that a new Exemption Code be added for these situations. Although verbal communication indicated that the IRS agreed with the recommendation, it has not yet been added to the list of Exemption Codes.

⁵²See, Form 1042-S Explanation of Codes: “Box 6. Exemption Code (applies if the tax rate entered in box 5 is 00.00).” The Exemption Code explanation for electronic submissions in Rev. Proc. 2010-38, Part C, Sec. 3, Recipient “Q” Records, p. 374, states “If the tax rate entered is 1% through 30%, enter “00””

⁵³However, the electronic edits for the Exemption Code allow Code 04 for records with a reduced rate. See Rev. Proc. 2010-38, Part A, Sec. 8 p. 353 which states: “...Do not use Exemption Code 4 unless a reduction [emphasis added] or exemption of tax is based on a treaty claim. Software systems that need to preserve the Exemption Code 04 with vendor income records subject to a reduced rate for withholding purposes, must replace Code 04 with Code 00 for reporting purposes. This probably does not always happen.

⁵⁴Large foreign vendors with sophisticated U.S. tax advisors should not be confused. However, smaller vendors typically seek the assistance smaller U.S. CPA firms, many lacking experience in cross-border matters and tax treaty claims. These return preparers will depend upon payer documents and tax return instructions, as will tax preparers for nonresident alien individuals.