

# DO YOU HAVE TO WITHHOLD 30% ON PAYMENTS TO A NON-U.S. INDEPENDENT CONTRACTOR?

**Author**  
Galia Antebi

**Tags**  
Independent Contractor  
Withholding Tax

## BACKGROUND

In the global village where we live, U.S. companies are not limited to U.S. individuals when searching for the right service provider. U.S. companies often hire non-U.S. individuals for the job. These individuals include non-U.S. citizens living outside the U.S., who generally don't need to be present in the U.S. to provide services, and non-U.S. citizens who are temporarily present in the U.S. on an appropriate visa.

Generally, temporary immigrants will be considered U.S. tax residents under the substantial presence rule if present in the U.S. for a sufficient number of days. However, in certain fact patterns, a special rule may exempt days of presence in the U.S. from being counted towards residence status. An example is an individual present in the U.S. under an F-1 (student) visa who is working during a period of optional practical training.

In connection with income from the performance of services, non-U.S. individuals are subject to U.S. tax only on U.S.-source income. With limited exceptions, compensation income is sourced to the location where the services are performed. As a result, no U.S. withholding tax would apply to compensation payment for an individual who is an independent contractor and the following conditions are met:

- The individual is not a U.S. tax resident.<sup>1</sup>
- The services are not performed while present in the U.S., in whole or in part.

Once services are performed in the U.S., even in part, the payment is considered to be a U.S.-source payment to a greater or lesser extent based on the quantum of services performed and the place or places where performed. Factors that are not relevant to the source of the income include the individual's place of residence, the place where the contract for service was entered, and the place of payment. When services are performed from both within and without the U.S., the payment must be allocated between the U.S. and the foreign country, generally on the basis of the time spent in each place for performance of services.

When a non-U.S. person performs personal services in the U.S. they are generally treated as engaged in a trade or business in the U.S. and tax is due on the U.S.-source portion of the compensation. When an employee-employer relationship exists, the tax is taken care of through graduated withholding in a similar manner to the way wages are withheld on for U.S. citizens and residents.<sup>2</sup> But when an

<sup>1</sup> Generally, a U.S. resident includes a U.S. citizen and a non-U.S. citizen who holds a green card or meets the substantial presence test. The determination of U.S. tax residency will not be discussed further in this article.

<sup>2</sup> Note that while the tax liability is taken care of via withholding, the non-U.S.

employment relationship is not established, and the relationship is that of an independent service provider, how is the U.S. tax liability settled? Is the independent contractor responsible for their own tax payment or is the principal company obligated to withhold 30% of the gross amount paid under the general statutory rule applicable to a non-U.S. person receiving fixed, determinable, annual, and periodic income (“F.D.A.P. payments”)?

## INDEPENDENT COMPENSATION INCOME IS SUBJECT TO 30% GROSS WITHHOLDING

As mentioned above, when a non-U.S. person provides services while in the U.S., the amount of the compensation payment allocated to the days spent in the U.S. will be U.S.-source income. A payment from U.S. sources made to a non-U.S. person is subject to withholding if it is an F.D.A.P. payment. F.D.A.P. payments include compensation payments in a non-employment setting. The withholding obligation is imposed on the “withholding agent” (generally, any person with control over the payment amount) who is personally liable for the tax, independently of the tax liability of the non-U.S. individual receiving the payment.

Stated differently, if the U.S. business fails to withhold and the service provider fails to satisfy the relevant U.S. tax liability, the U.S. business will be liable (alongside the non-U.S. individual) for the tax, including interest and penalty. The tax obligation of the withholding agent is 30% of the amount paid. Whichever way imposed, the tax due will be collected only once, but it is generally easier for the I.R.S. to go after the withholding agent in the U.S. rather than the non-U.S. individual based abroad. Lastly, even if the service provider satisfies its U.S. tax liability, the U.S. business is personally liable for any interest and penalties for failure to withhold from the time withholding is due until the non-U.S. individual reports the income on a U.S. tax return and pays the tax.

Consequently, unless an exception applies, a U.S. business hiring a non-U.S. individual as a service provider must withhold 30% on compensation payments made for services performed in the U.S. Looked at it this way, collection of the tax – and reduction of the gross amount paid to the non-U.S. individual – benefits the U.S. business.

## WHAT AMOUNT IS SUBJECT TO WITHHOLDING?

A U.S. business payor making a compensation payment to a non-U.S. independent contractor must withhold an amount sufficient to ensure that at least 30% of the amount subsequently determined to be U.S.-source income is withheld. This may be difficult to determine, especially because at the time of payment many of the facts leading to this determination may still be unknown. This, of course, can lead to overwithholding.

Payment for reimbursement of travel and lodging expenses of a non-U.S. individual providing independent services are not subject to withholding if the payments are treated as made under an accountable plan. In general, this a plan that

---

individual is considered to be engaged in a U.S. trade or business and is thus required to file a U.S. tax return on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*.

***“If the U.S. business fails to withhold and the service provider fails to satisfy the relevant U.S. tax liability, the U.S. business will be liable.”***

- establishes the business purpose and connection of the expenses,
- substantiates the expenses claimed within a reasonable period of time, and
- requires the independent contractor to return to the payor within a reasonable period of time any advanced amounts that are above the substantiated business expenses.

## CAN COMPENSATION INCOME BE EXEMPT FROM WITHHOLDING?

Treaties may exempt independent personal services payments from withholding under a special provision for independent personal services or, if such a provision is not available, by treating such income as business income, which is taxed under the business profits article of the treaty. Generally, to be eligible for treaty benefits under the relevant provision of a treaty, the service provider cannot have an office or a fixed base in the U.S. available for the performance of services or be present in the U.S. for a specified number of days. To avoid withholding based on a treaty benefit the U.S. business payor must receive from the independent contractor Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, in advance of making the payment. Once the form is received, the U.S. business must review it to determine if the benefit is warranted under the relevant facts, then sign it and submit a copy of it to the I.R.S. within five days of receipt. The U.S. business must then wait at least ten days to see if the I.R.S. has any objections.

The table below summarizes the treatment under some treaties with respect to compensation income earned by an independent contractor.

U.S. Tax Treaty	Independent Personal Services	Business Profits
Canada	N/A	Exempt from tax unless the individual has a permanent establishment ("P.E.") in the U.S. and the compensation income is attributable to such P.E.
China	Exempt from tax unless  the compensation income is attributable to the individual's fixed base ("F.B.") <sup>3</sup> in the U.S. which is regularly available to them for the purpose of performing their services <sup>4</sup> , or  the services are performed in the U.S. and the individual is present in the U.S. for 183 days or more in the taxable year.	N/A

<sup>3</sup> Fixed base is not defined but the meaning is understood to be similar to P.E.

<sup>4</sup> If this condition is met, services that are performed outside the U.S. may still be subject to U.S. tax if they are attributable to the individual's U.S. F.B. Compare

U.S. Tax Treaty	Independent Personal Services	Business Profits
<b>France</b>	Exempt from tax unless the services are performed in the U.S. and the compensation income is attributable to the individual's F.B. in the U.S. that is regularly available to the individual for the purpose of performing their services	N/A
<b>Germany</b>	N/A	Exempt from tax unless the individual has a P.E. in the U.S. and the compensation income is attributable to such P.E.
<b>Italy</b>	Exempt from tax unless the services are performed in the U.S. and the compensation income is attributable to a U.S. F.B. that is regularly available to the individual for the purpose of performing their service	N/A
<b>Israel</b>	Exempt from tax unless the services are performed in the U.S. and the individual is present in the U.S. for 183 days or more in the taxable year	N/A
<b>Japan</b>	N/A	Exempt from tax unless the individual has a P.E. in the U.S. and the compensation income is attributable to such P.E.
<b>Thailand</b>	Exempt from tax unless <sup>5</sup> <ul style="list-style-type: none"> <li>• the compensation income is attributable to the individual's F.B. in the U.S. which is regularly available to him for the purpose of performing their services,<sup>6</sup></li> <li>• the services are performed in the U.S. and the individual is present in the U.S. for 90 days or more in the taxable year, or</li> <li>• the compensation income exceeds \$10,000 for the taxable year.</li> </ul>	N/A

this to the U.S. Model Treaty and other treaties that still include a separate provision for Independent Personal Services, where the services must be performed in the U.S. to be subject to U.S. tax. Additionally, if this condition is met, it is understood that the principles of the Business Profits provision would apply in computing the individual's income (*i.e.*, U.S. tax would apply on a net basis).

<sup>5</sup> It is understood that the principles of the Business Profits provision would apply in computing the individual's income if it is taxable pursuant to this provision (*i.e.*, U.S. tax would apply on a net basis).

<sup>6</sup> If this condition is met, services that are performed outside the U.S. may still

U.S. Tax Treaty	Independent Personal Services	Business Profits
U.K.	N/A	Exempt from tax unless the individual has a permanent establishment P.E. in the U.S. and the compensation income is attributable to such P.E.

\*Note that compensation income of entertainers and sportsmen (artists and athletes) may benefit from a separate provision of tax treaties and are not addressed in this article.

Often, the facts required for the treaty provision to apply (as seen in some examples in the table above) cannot be determined at the time of the payment, and possibly until after the close of the tax year. Therefore, in many cases, even if a Form 8233 is submitted, the U.S. business payor should not accept the form and withhold 30% of a payment made.<sup>7</sup>

Additionally, under a special arrangement up to a maximum of \$5,000 of the final payment of compensation during a tax year may be exempt from withholding if the individual obtains an exemption letter from the I.R.S. This would require submitting a statement that meets certain information requirements relating to the individual's effectively connected income ("E.C.I.") earned during the year, tax withheld, any other tax liabilities, and other relevant matters. This statement must be signed under penalty of perjury by the individual and all withholding agents who made or are expected to make compensation payments to the individual during the taxable year.

## TAX LIABILITY OF THE SERVICE PROVIDER

Because the performance of services in the U.S. is generally treated as a U.S. trade or business, the income generated is generally E.C.I. and business expenses are allowed as a deduction. Therefore, the 30% tax on the gross amount paid often is greater than the net tax due on the tax return of the non-U.S. individual. Additionally, if withholding was imposed (as it should) the non-U.S. independent contractor should file a U.S. tax return on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, and claim a refund for any overwithholding. This entails obtaining a taxpayer identification number ("I.T.I.N.") by filing a Form W-7, *Application for IRS Individual Taxpayer Identification Number*, which can take up to seven weeks if completed correctly and all supporting documents required have been submitted or up to 11 weeks if submitted during peak processing times.

## REPORTING OBLIGATIONS FOR U.S. BUSINESSES

Payments potentially subject to withholding must be reported by the U.S. business making the payment on Form 1042-S, even if some or none of the payment is

---

be subject to U.S. tax if they are attributable to a U.S. F.B.; For example, if a Thai independent contractor has a U.S. office regularly available to him for the performance of his services, and the services he performs require him to visit Canada, it is possible that the income from the services performed in Canada may be attributable to his U.S. office and subject to U.S. tax.

<sup>7</sup> 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*, should not be used for compensation income.



actually subject to withholding. An example of a fact pattern resulting in some withholding involves an individual who provides services in the U.S. and outside the U.S. An example of a fact pattern resulting in no withholding involves a complete exemption by virtue of an applicable treaty. Additionally, all amounts of tax actually withheld during a taxable year must be reported by the withholding agent on Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*.

Both Form 1042 and 1042-S must be submitted by the U.S. business by March 15 of the following year, and a copy must also be sent to the payee, who may rely on it to demonstrate the amount of tax withheld should a refund be claimed on an income tax return.

## INDEPENDENT CONTRACTOR

Different responsibilities and liabilities would apply to the U.S. business if it was viewed to be an employer. Determining the character of the relationship as either (i) a principal and its independent contractor or (ii) an employer and its employee is important.

An independent contractor relationship is often desired by a U.S. business because it results in much lower costs for the U.S. business when the facts support that relationship. It also benefits the non-U.S. individual who hopes to avoid interfacing with a U.S. bureaucracy. In all cases, it is the facts and circumstances that control the determination, not the title that appears on the contract or a statement that appears towards the end of many contracts.

The Code defines an employee under common law rules. Under common law rules, an employer-employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, both as to the result to be accomplished by the work, and as to the details and means by which that result is accomplished. The fact that the employer does not actually direct or control the manner in which the services are performed is immaterial. The fact the business has the right to do so controls. However, if an individual is subject to the control or direction of another merely with regard to the intended result of the work and not as to the means and methods for accomplishing the result, the individual is treated as an independent contractor.

Factors that may be considered in this determination, but are not conclusive, include whether the individual is furnished with tools and with a place to work on the premises of the person receiving the services.

If a U.S. business unreasonably treats an employee as an independent contractor, the U.S. business is liable for employment taxes for that worker.

## CONCLUSION

U.S.-source compensation payments made by a U.S. business to a non-U.S. individual who is an independent contractor and who is not treated as a U.S. tax resident for the taxable year will generally be subject to 30% gross withholding.

While the ultimate U.S. tax liability of the non-U.S. service provider may very well be lower, gross withholding tax should be collected by the U.S. business and paid

over to the I.R.S. unless the U.S. business payor can confidently determine that a lesser amount is subject to withholding or that treaty benefits can be extended to the non-U.S. service provider. Otherwise, the tax liability becomes that of the payor.

Thus, a U.S. business must balance the detriment to the service provider with the business risk resulting from the under-withholding tax.

***“U.S.-source compensation payments made by a U.S. business to a non-U.S. individual who is an independent contractor and who is not treated as a U.S. tax resident for the taxable year will generally be subject to 30% gross withholding.”***

***Disclaimer:*** This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.