

US Tax Code Section 1441: Withholding & Reporting Requirements

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Enforcement of the tax withholding and reporting obligations imposed upon U.S. entities, with respect to payments to non-US citizens, has without doubt become one of the hottest topics at the Internal Revenue Service (IRS). As evidence of the importance the IRS is placing on this issue, withholding tax has now been designated as a Tier I issue. At issue, is Section 1441 of the tax code which stipulates that payments made to a non-U.S. citizen for services performed in the United States are subject to withholding tax. Many U.S. companies, however, are yet either unfamiliar with the applicable rules, or are unaware of the significant risks of non-compliance. This legal alert reviews the IRS protocols relating to withholding tax and outlines key points that US entities making payments to non-U.S. citizens should review to assess their level of compliance.

Section 1441 generally requires a US entity to withhold and deposit 30 percent of payments made to non-US citizens. For the purpose of Section 1441, payments made to a non-U.S. citizen need not be made annually or at regular intervals, as long as they are paid from time to time. Common examples of payments include interests, dividends, salaries, wages, premiums and annuities. Even scholarships, fellowships, grants, prizes or awards made to non-U.S. citizens in connection with activities the non-U.S. citizens have performed must withhold U.S. tax from such payments. Often, US entities that are

subject to section 1441 are financial institutions, but they can include any individual, business, partnership, trust, estate or other entity paying U.S. source income to a non-U.S. citizen or entity in exchange for services. Entertainment, technology, energy, and pharmaceutical industries could all be especially vulnerable, as well as law and accounting firms and universities.

U.S. entities making payments to non-US citizens also have reporting requirements. They must annually file Form 1042 to report their total withholding tax liability, amounts withheld, reportable amounts paid to foreign persons and other relevant information. Any U.S. person who fails to withhold or properly document why they did not withhold can be personally liable for the under withheld tax, as well as for interests and penalties. The standard 30-percent withholding rate may be reduced or eliminated based on an applicable treaty or provision but there are stringent documentation requirements associated with claiming those exemptions.

The IRS is now in the process of increasing its enforcement activity surrounding payments to non-U.S. citizens. Given the IRS's current focus to ensure compliance with the section 1441 rules, every US entity making payments to non-U.S. citizens has reason to be concerned about this increased enforcement activity. While financial institutions typically have a better understanding of their tax compliance obligations because they have many other related rules to follow, companies outside the banking sector can struggle with compliance. Many companies are unaware that they must file Form 1042 with the IRS, which reports the tax withheld to those persons. Such companies need to take a hard look at their cross-border withholding procedures and act quickly to correct any deficiencies.

That means conducting internal “health check” to determine whether they are making payments to non-U.S. citizens, and if so, whether they are in compliance with their withholding and reporting obligations.