

## **Compliance Alert- U.S. Withholding on Payments to Puerto Rican Persons/Entities & Other Information Reporting Requirements**

Many Puerto Rico Act 60 companies and individuals holding export service decrees receive service fees from U.S.-based companies. The U.S. companies paying these fees may be unpleasantly surprised when the IRS assesses them with a 30% tax on the total fees paid to the Puerto Rican service provider for failure to comply with U.S. information reporting and withholding requirements.

A large area of noncompliance that we see on a regular basis involves the failure by U.S. companies to obtain necessary tax reporting documentation from their Puerto Rico service providers. This documentation is crucial for the U.S. companies to determine their U.S. information reporting and withholding requirements on payments to their Puerto Rico service providers. The sections of the Internal Revenue Code<sup>1</sup> that deal with the information and withholding requirements for payments to non-U.S. persons<sup>2</sup> are incredibly complex and confusing. This article attempts to break down, in layman's terms, the various information reporting and withholding requirements for those U.S.-based companies or persons that pay fees to Puerto Rico-based companies or persons.

### **Background of a Typical Situation**

USCo, a U.S. C corporation, makes payments to two Puerto Rican corporations: PRCo1 and PRCo2. PRCo1 and PRCo2 are not financial institutions and are each wholly owned by bona fide residents of Puerto Rico.

The payments to PRCo1 are for services that PRCo1 wholly performs in Puerto Rico. PRCo1 is not engaged in a U.S. trade or business and is not required to file a U.S. tax return.

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<sup>1</sup> All section references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

<sup>2</sup> Puerto Rico is treated as a foreign country for most U.S. tax purposes. Code §7701(a)(9) ("The term 'United States' when used in a geographical sense includes only the States and the District of Columbia.").

The payments to PRCo2 are for services that PRCo2 partly performs in Puerto Rico and partly performs in the U.S. PRCo2 is engaged in a U.S. trade or business and annually files Form 1120-F to pay U.S. corporate income tax and U.S. branch profits tax on its U.S. effectively connected income.

USCo also makes payments to Brad, a U.S. citizen who is a bona fide resident of Puerto Rico. Brad is not an employee of USCo. Instead, Brad is an independent contractor. The payments to Brad are for services that he performs entirely in Puerto Rico.

PRCo1, PRCo2, and Brad are not related to USCo or to each other.

### Form 1099 Reporting of Payments for Services to U.S. Persons

Code §6041(a) generally requires all persons engaged in a trade or business who make payments in the course of the trade or business to another person of various types of income of \$600 or more in any year to file an information return (typically Form 1099) with the IRS setting forth the amount of the income and the name and address of the recipients of the payments.

The recipient's taxpayer identification number ("TIN") generally must be included on the Form 1099. The payor generally requests that the recipient complete Form W-9, *Request for Taxpayer Identification Number and Certification*.

If the recipient refuses to provide their TIN, the payor generally must backup withhold on the payments.<sup>3</sup> Under current law, the backup withholding rate is 28%.<sup>4</sup>

Payments to foreign recipients generally do not need to be reported on Form 1099.<sup>5</sup> However, payments to foreign recipients may be subject to a separate withholding and reporting regime (discussed below). PRCo1 and PRCo2 are foreign persons.<sup>6</sup> Therefore, Form 1099 reporting and backup withholding would not apply to USCo's payments to them.

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<sup>3</sup> Code §3406.

<sup>4</sup> Code §3406(a)(1) ("the fourth lowest rate of tax applicable under section 1(c)").

<sup>5</sup> Treas. Reg. §1.6041-4.

<sup>6</sup> Under Code §7701(a)(4) the term "domestic", when applied to a corporation, means created or organized in the United States or under the law of the United States or of any State. Also, Code §7701(a)(9) defines the term "United States" to

### USCo Payments to Brad

Brad is a U.S. citizen. Therefore, he is a U.S. person.<sup>7</sup> This means that USCo should ask Brad to complete a Form W-9.

Although USCo generally reports payments to independent contractors on Form 1099, because Brad is a bona fide resident of Puerto Rico and because all of the services are performed from Puerto Rico, USCo is not required to report the payment to Brad on Form 1099. Treas. Reg. §1.6049-5(c)(5)(ii) provides:

U.S. payors are not required to report on Form 1099 income that is from sources within a possession of the United States and that is exempt from taxation under section 931, 932, or 933 \* \* \*. \* \* \* [A] U.S. payor may treat the beneficial owner as a bona fide resident of the possession of the United States from which the income is sourced if, prior to payment of the income, the U.S. payor can reliably associate the payment with valid documentation that supports the claim of residence in the possession of the United States from which the income is sourced.  
\* \* \*

Because Brad is a bona fide resident of Puerto Rico and he earns the income from within Puerto Rico, the income is Puerto Rican-source income that can be excluded from Brad's U.S. taxable income under Code §933. Thus, if USCo obtains from Brad valid documentation that supports his claim of residence in Puerto Rico and that the income is Puerto Rican-source income, then USCo does not need to report the income to Brad on Form 1099.

The IRS has not issued guidance on how to obtain such documentation. A statement attached to the Form W-9 (signed under penalties of perjury) that certifies Brad is a bona fide resident of Puerto Rico and that all of the income is from services that take place in Puerto Rico should be sufficient documentation for USCo to avoid 1099 reporting of the payments.

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include only the States and the District of Columbia. Puerto Rican corporations are generally not considered domestic corporations. Instead, they are considered foreign corporations.

<sup>7</sup> Code §7701(a)(30)(A).

### USCo Payments to PRCo1

Code §§1441 and 1442 generally place a duty on all persons having the control, receipt, custody, disposal, or payment of certain income items of foreign persons to withhold 30% U.S. tax on such income items.<sup>8</sup> The income items include gross income from services where the services take place in the U.S. (i.e., where the income is U.S.-source income).<sup>9</sup>

The required rate of withholding is often reduced by income tax treaties.<sup>10</sup> However, the U.S. does not have an income tax treaty with Puerto Rico. Therefore, U.S.-source income paid to a Puerto Rican corporation is generally subject to a 30% U.S. withholding tax.

The payments made by USCo to PRCo1 are for services wholly performed in Puerto Rico. Consequently, all of the income that PRCo1 earns from USCo is Puerto Rican-source income.<sup>11</sup>

Because the payments are not U.S.-source income, as long as PRCo1 provides a Form W-8BEN-E to USCo (prior to the payment), USCo should not need to withhold on the payments it makes to PRCo1.<sup>12</sup>

USCo does not need to report the payments to PRCo1 on Form 1042 or 1042-S, again because the payments are not U.S.-source income.<sup>13</sup>

USCo does not need to withhold U.S. tax under Chapter 4 of the Internal Revenue Code<sup>14</sup> as long as PRCo1 indicates on the W-8BEN-E that its Chapter 4 status (Line 5 of Form W-8BEN-E) is an “Excepted Territory NFFE.” PRCo1 is an excepted territory non-financial foreign entity (“NFFE”)

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<sup>8</sup> Code §§1441(a), 1441(b), and 1442(a).

<sup>9</sup> *Id.*

<sup>10</sup> Treas. Reg. §1.1441-6.

<sup>11</sup> Code §861(a)(3) and Treas. Reg. §1.861-4.

<sup>12</sup> Treas. Reg. §1.1441-2(a) (“[T]he term *amounts subject to withholding* means amounts from sources within the United States \* \* \*.” Italics in original.).

<sup>13</sup> Code §1461 and Treas. Reg. §1.1461-1(c)(2).

<sup>14</sup> Code §§1471-1474.

because it is incorporated in Puerto Rico and it is wholly owned by bona fide residents of Puerto Rico.<sup>15</sup>

### USCo Payments to PRCo2

The payments made by USCo to PRCo2 are for services partly performed in Puerto Rico and partly performed in the U.S. Here, not all of the income paid by USCo to PRCo2 is Puerto Rican-source income.<sup>16</sup> Only the portion of the services income earned from activities performed in Puerto Rico is considered Puerto Rican-source income.<sup>17</sup>

By signing Form W-8BEN-E, PRCo2 certifies that the income being received is “not effectively connected with the conduct of a trade or business in the United States”.<sup>18</sup> A portion of PRCo2’s income is U.S. effectively connected income (“ECI”). Thus, PRCo2 cannot simply provide a Form W-8BEN-E to USCo to avoid withholding.

Under the regulations related to Form W-8, the Form W-8 is generally known as the “withholding certificate”,<sup>19</sup> the U.S. payor is known as the “withholding agent”,<sup>20</sup> and the recipient of the income is known as the “beneficial owner”<sup>21</sup> of the income. These regulations contemplate providing two withholding certificates (a W-8ECI for ECI and a W-8BEN-E for non-ECI). Treas. Reg. §1.1441-1(e)(2)(i) provides in part:

\* \* \* If the beneficial owner receives more than one type of payment from a single withholding agent, the beneficial owner may have to submit more than one withholding certificate to the single withholding agent for the different types of payments \* \* \*. For example, if a beneficial owner claims that some but not all of

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<sup>15</sup> Treas. Reg. §1.1472-1(c)(1)(iii) and Treas. Reg. §1.1471-1(b)(129).

<sup>16</sup> Code §861(a)(3) and Treas. Reg. §1.861-4.

<sup>17</sup> This article does not address whether the income earned outside of Puerto Rico would qualify for a reduced rate of Puerto Rican corporate income tax under Act 60. This is a question that should be discussed with your Puerto Rican tax advisor.

<sup>18</sup> See the third bullet in Part XXX of Form W-8BEN-E.

<sup>19</sup> Treas. Reg. §1.1441-1(b)(2)(i).

<sup>20</sup> Treas. Reg. §1.1441-7(a)(1).

<sup>21</sup> Treas. Reg. §1.1441-1(c)(6).

the income it receives is effectively connected with the conduct of a trade or business in the United States, it may be required to submit two separate withholding certificates, one for income that is not effectively connected and one for income that is so connected. \* \* \*

PRCo2 is the beneficial owner. USCo is the withholding agent. Because PRCo2 is receiving more than one type of payment from USCo, PRCo2 can submit two W-8s for the different types of payments. For example, PRCo2 can provide a Form W-8ECI for the income it receives from USCo that is ECI, and PRCo2 can provide a Form W-8BEN-E for the income it receives from USCo that is not ECI.

USCo would not need to withhold on the U.S.-source income that is ECI,<sup>22</sup> and USCo would not need to withhold on the non-U.S. source income that is not ECI.<sup>23</sup>

The regulation does not indicate that two separate payments need to be made (e.g., one for ECI and one for non-ECI). However, it would make sense for PRCo2's invoices to USCo each month to identify the portion of the invoice that relates to ECI and the portion that relates to non-ECI. This approach informs USCo as to what portion of the services were ECI and what portion of the services were not ECI.

USCo needs to report the U.S.-source payments (i.e., the ECI portion) to the IRS on Forms 1042 and 1042-S.<sup>24</sup>

USCo does not need to withhold U.S. tax under Chapter 4 of the Internal Revenue Code<sup>25</sup> as long as PRCo2 indicates on the W-8BEN-E that its Chapter 4 status (Line 5 of Form W-8BEN-E) is an "Excepted Territory NFFE." PRCo2 is an excepted territory NFFE because it is incorporated in Puerto Rico and it is wholly owned by bona fide residents of Puerto Rico.<sup>26</sup>

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<sup>22</sup> Code §1441(c) and Treas. Reg. §1.1441-4.

<sup>23</sup> Treas. Reg. §1.1441-1(b)(1) and Treas. Reg. §1.1441-2(a).

<sup>24</sup> Code §1461 and Treas. Reg. §1.1461-1.

<sup>25</sup> Code §§1471-1474.

<sup>26</sup> Treas. Reg. §1.1472-1(c)(1)(iii) and Treas. Reg. §1.1471-1(b)(129).

### USCo Is Liable for the Tax If It Fails to Withhold

A taxpayer, who is required to withhold tax under Code §1441 on a payment to a foreign person, is itself liable for the tax if it fails to withhold.<sup>27</sup> Thus, if USCo is required to withhold on payments to PRCo2, but USCo fails to withhold the tax, USCo will be liable for the tax itself.

Not only can USCo be liable to the tax itself, but USCo can also be subject to a 25% penalty for failing to file Form 1042 and a 10% penalty for failing to deposit the tax.<sup>28</sup>

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### **About Tom Duffy, C.P.A., P.A. & P.C.**

Tom Duffy C.P.A., P.A. & P.C. is a Greater Chicago-based firm that specializes in international taxation with a particular focus on U.S. possessions. In addition, the firm is one of the few CPA firms in the country that specializes in representing residents of Puerto Rico during IRS examinations, specifically those taxpayers granted tax incentives under Puerto Rico's Act 60 (formerly Act 20/22).

Our foreign clients rely on our knowledge and expertise in complying with their U.S. tax obligations. Tom Duffy has over fifteen years of experience in international tax planning and associated U.S. tax return preparation. The firm services clients in the United States, its possessions, and throughout the world. Tom Duffy is a member in good standing with the American Institute of CPAs and the Puerto Rico Society of CPAs. He is licensed to practice in Florida, Illinois, and Puerto Rico.

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<sup>27</sup> Code §1461. *A.C. Monk & Co. v. Commr.*, 10 T.C. 77 (1948) (A domestic corporation was held liable for the tax it failed to withhold from payments of interest to a nonresident alien.), *A. Gusmer, Inc. v. McGrath*, 196 F.2d 860 (D.C. Cir. 1952) (“[I]t was [the taxpayer’s] own omission of a statutory duty to withhold the taxes from funds in its hands which created the problem.”).

<sup>28</sup> Code §§6651 and 6656. *A.C. Monk & Co. v. Commr.*, 10 T.C. 77 (1948) (A 25% penalty was imposed for failure to file Forms 1042 and 1042-S because the taxpayer did not have reasonable cause for failure to file the forms), *Ellwest Stereo Theatres of Memphis v. Commr.*, 70 T.C.M. 1655 (1995) (The taxpayer was subject to penalties for failure to file Form 1042 and failure to deposit the tax. The taxpayer did not have reasonable cause for the failure.). In *L.D. Caulk Co. v. U.S.*, 116 F. Supp. 835 (D. Del. 1953), the court held that the taxpayer had reasonable cause because it relied on the advice of a Certified Public Accountant.