

**FINAL REGULATIONS ON TAX WITHHOLDING AFFECT CERTAIN
GRANTS TO FOREIGN PERSONS FOR ACTIVITIES
CONDUCTED WITHIN THE UNITED STATES**

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The Internal Revenue Service has published amendments to final regulations relating to withholding of income tax under sections 1441, 1442 and 1443 of the Internal Revenue Code of 1986, as amended (the "Code"), on certain U.S.-source income paid to foreign persons. In general, the regulations do not impose withholding tax on any payment or recipient of a payment that is not already subject to withholding under the current rules. The regulations do provide new procedures for determining whether a payment is exempt from withholding. The regulations are effective January 1, 2001. The final regulations are 244 pages long. Therefore, the explanation which follows is only a summary of the significant provisions for public charities and private foundations.¹

BACKGROUND

In general, if a U.S. entity makes a fixed or determinable annual or periodic payment, which includes a grant, to a nonresident alien individual, foreign corporation or foreign trust (a "foreign grantee"), it is required to withhold a percentage of that payment if the payment is deemed to arise from a U.S. source.² Pursuant to Treasury regulations promulgated in 1995, scholarships, fellowship grants, grants, prizes, and awards paid by U.S. private foundations or public charities are generally deemed to be U.S.-source income and are subject to withholding if paid to foreign grantees. According to these regulations, scholarships, fellowship grants, targeted grants and achievement awards with respect to activities conducted outside the United States are deemed to be foreign-source income and are not subject to withholding.

¹ This memorandum does not address payments made to foreign persons a compensation for personal services.

² In general, the U.S. entity must withhold 30% of the payment. However, the rate is lowered to 14% for nonresident aliens with certain visas who receive scholarship to study in the United States.

QUALIFYING FOR AN EXEMPTION FROM
WITHHOLDING

Although a U.S. public charity or private foundation must withhold on a grant to a foreign grantee where some or all of the grant activities are performed in the United States, two exemptions are available. The foreign grantee may establish that (i) it could qualify as a U.S. tax-exempt organization, or (ii) it qualifies for an exemption under a tax treaty. The regulations set forth new procedures that must be followed before a U.S. public charity or private foundation may rely on these exemptions and thus not withhold from grants made to foreign persons for grant activities to be performed in the United States.

No withholding is required on amounts paid to a foreign grantee for use within the United States if the grantee is described in Code section 501(c) and the amounts paid are not unrelated business taxable income. To qualify for this exemption, a foreign grantee must provide Form W-8EXP.³ The Form W-8EXP must include the grantee's taxpayer identification number and must certify (i) that the Internal Revenue Service (the "IRS") has issued a determination letter (and the date thereof) that is currently in effect; (ii) the amount, if any, that is unrelated business taxable income; and (iii) whether the grantee is a private foundation or public charity.⁴ If the grantee does not have a determination letter, it may attach an opinion from U.S. counsel that the grantee is described in Code section 501(c). If the grantee states that it is a public charity, the grantee must provide an affidavit setting forth sufficient facts concerning its operations and support for the IRS to determine that the grantee would be likely to qualify for public charity status. Any opinion of counsel or affidavit must be renewed whenever there is a change in facts or circumstances relevant to the grantee's status under 501(c) or as a public charity.

If a foreign grantee is claiming an exemption under a tax treaty, the grantee must provide a completed Form W-8BEN.⁵ The foreign grantee must provide a taxpayer identification number (or social security number if an individual) and the provision under which it is claiming exemption. A foreign exempt organization should only use Form W-8BEN if it is applying for an exemption based on a tax treaty. If the foreign exempt organization is relying on its status under Code section 501(c), it should use Form W-8EXP.

A U.S. public charity or private foundation may be subject to penalties if it fails to withhold when required to do so, or if it fails to withhold without receiving the required documentation. Public charities and private foundations that make grants to foreign persons for

³ This form replaces Form 8709.

⁴ Treas. Reg. § 1,1441-9(b)(2).

⁵ Treas. Reg. § 1.1441-6(b). This form replaces Form 1001.

use within the United States should consult with their accountants and take steps to ensure that the required documentation is collected and that withholding is implemented where necessary.

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If you would like further information or assistance regarding the final regulations, please call Victoria B. Bjorklund (212-455-2875), Jennifer I. Goldberg (212) 455-2287, or any other member of our Exempt Organizations Department.

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