Withholding Tax on Payments to Foreign Persons

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“No man can serve two masters” †

The United States taxes the income of foreign persons in two different ways. If the foreign person is doing business in this country, the United States taxes his business-related income, net of deductions, at progressive rates.¹ Income of foreign persons not connected with a U.S. business is taxed, without any deductions, at flat rates, but only if it is from sources within the United States and is of a special character.²

Long-standing international legal principles make it very difficult for any country to collect taxes from foreign persons outside of its borders.³ Thus, to protect its revenue, the United States requires the withholding of income taxes from certain payments made to foreign persons.⁴ Almost all of the items subject to flat-rate, gross-amount income tax are also subject to this regime of withholding. Only a small class of business-related income is subject to this sort of withholding.⁵ This article will first briefly explore the patterns of such withholding, and will then focus on the problems of withholding agents.

Introduction

There is a significant distinction between having jurisdiction to impose a tax and having the ability to collect it. There is no practical limitation on the ability of the United States to impose taxes on foreign

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² Matthew 6:24 (King James).

³ See the text accompanying Ns. 8–10 infra.

⁴ I.R.C. §§ 1441–1464. These sections constitute chapter 3 of subtitle A of the Internal Revenue Code.

⁵ Compensation for personal services is subject to chapter 3 withholding under certain circumstances. I.R.C. § 1441(c)(1). See the text accompanying Ns. 77–88 infra.