

2.007 Tax Treatment of Compensation (Services, Rents, and Royalties)

This policy addresses the tax treatment of compensation (compensatory payments) paid to individuals and entities for services, rents, and royalties. Payments for related business expenses are addressed in [Policy 2.008 Tax Treatment of Business Expenses \(Service-Related\)](#).

This policy does not apply to payments made to RCUH and UH employees. Reimbursements for travel and other expenses incurred by RCUH and UH employees are addressed in the policies under [2.600 Travel](#), and in [Policy 2.703 Employee Business Expense Reimbursements \(AFP Form\)](#).

I. Details of Policy

A. Types of Payments

1. Services

- a. *Payments to Consultants/Professionals/Other Independent Contractors* – Payments are made for advice or other specialized services that are usually not available within the institution.
- b. *Honorarium Payments* – An honorarium is a voluntary payment given to a person for a special or distinguished service, for which custom or propriety precludes setting a fixed price (an honorarium does not rise to the level of fair market value for the services rendered). An example of an honorarium payee is a guest speaker.

2. Rents

- a. *Real Property and Equipment Rentals* – This includes rental payments for office space and other real property, as well as payments to rent equipment/machines (e.g., office machines, laboratory equipment, etc.).
- b. *Database Rentals* – Payments for the use of a database are generally considered rental payments if the use is limited to accessing actual data (e.g., articles, documents, etc.), rather than utilizing software.

3. Royalties

A royalty is a payment to the owner of intangible property (such as software, copyrights, patents, and trademarks), for the right to use the intangible property.

- a. A royalty may be paid to an author to publish or otherwise distribute his/her written works, or to an artist to display, distribute, or copy his/her work of art (e.g., pictures, movies, etc.).
- b. A royalty may also take the form of a payment for the right to use software programs for a certain period of time, or by a certain number of users (also known as a license fee). However, if the software agreement includes a sale of the source code for the product (or is a one-time purchase of software with no recurring fees or time limits on the use (i.e., off-the-shelf or shrink-wrapped software)), this constitutes a purchase of goods, rather than a royalty. Software maintenance agreements are generally considered services.
- c. *Software Royalty Income Sourcing Rules for Foreign Persons* – In addition to the general tax guidance for royalty payments provided in Section I.C under GENERAL TAX TREATMENT OF PAYMENTS below, the following rules should also be followed when determining whether a royalty payment to a foreign vendor (individual or entity) is considered foreign source income (foreign persons' foreign source income is not subject to U.S. taxation):
 - i. When the software is used or distributed in the U.S. (e.g., if the software source code is downloaded and installed on servers in the U.S.) it is considered U.S. source income, even if the software or property originates or is housed on servers outside the U.S.
 - ii. The income is considered foreign source if the software source code (housed on servers outside the U.S. or on a cloud) is not downloaded onto servers/computers in the U.S.

B. Procuring Services, Rents, and Royalties

Use a purchase order (PO) to procure services, rents, and royalties. The PO should be in the name of the individual or entity who is the beneficial owner of the income, and who will be responsible for the taxation of any income. If an honorarium payment is being made together with related travel expenses, the [Non-Employee Expense Payment Form](#) may be used.

In order to properly determine whether the payment for services is U.S. source income or foreign source income to the service provider, it is important to document the location where the services will be performed in the Scope of Service section of the Agreement for Services. Refer to [Policy 2.204 Services Agreements](#).

C. General Tax Treatment of Payments

1. Payments to U.S. Citizens, Permanent Resident Aliens, Resident Aliens, and U.S. Entities
 - a. All payments for services and rents must be reported on an IRS Form 1099-Misc if the recipient's cumulative annual payment is \$600 or greater; for royalties, the reporting threshold is \$10 or greater.

- b. *Exceptions* – Payments to corporations (including limited liability companies treated as corporations) are not required to be reported on an IRS Form 1099-Misc unless the payments are for attorneys' fees or medical/healthcare costs. Payments for rent to real estate agents are also not required to be reported.
- c. *Immigration Requirements* – It must also be determined whether resident aliens are eligible to receive payments from RCUH based on their immigration status. See Immigration Requirements for Foreign Nationals (Permanent Resident Aliens, Resident Aliens, and Nonresident Aliens) in [Policy 2.012 Requirements When Paying Foreign Persons](#) for guidance regarding immigration requirements.
- d. *Required Documents* – Refer to [Policy 2.011 Requirements When Paying U.S. Persons](#) for detailed information.
 - i. Individuals –
 - (1) IRS Form W-9 – Required for U.S. citizens and permanent resident aliens who are paid for **only** services, rents, or royalties.
 - (2) UH Form WH-1 – Required for U.S. citizens and permanent resident aliens who are **also** reimbursed for their expenses in addition to services, rents, or royalties.
 - (3) UH Form WH-1 – Required for resident aliens.
 - ii. Entities – IRS Form W-9

2. Payments to Nonresident Alien Individuals and Foreign Entities

- a. All payments to nonresident alien individuals and foreign entities must be submitted manually to RCUH Disbursing to ensure that the proper tax withholding and reporting is performed. Payments may be subject to tax withholding at the statutory rate of 30%, and are also required to be reported on an IRS Form 1042-S. The withholding rate may be reduced or eliminated by the Internal Revenue Code (IRC) or tax treaty exemptions discussed below.
- b. *Tax Exemptions/Exclusions*
 - i. Tax Treaty – Nonresident alien individuals and foreign entities may be entitled to tax treaty reductions or exemptions from withholding. Individuals use IRS Form 8233 and entities use IRS Form W-8BEN-E to claim tax treaty benefits, and either a U.S. taxpayer identification number (TIN) or foreign taxpayer identification number is required. Programs must obtain the applicable form from the individual/entity and submit the form to RCUH Disbursing. The payment must still be reported on an IRS Form 1042-S even if a treaty reduces or exempts a payment from tax withholding. The United States has tax treaties with a number of foreign countries. See <https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z>.

- ii. Income Source – Nonresident alien individuals and foreign entities are taxed on U.S. source income only. Payments for services are sourced to the country where the services are performed. If services are performed outside of the 50 U.S. states and the District of Columbia, it is considered foreign source income and is not subject to U.S. taxation. If the services are performed both within and outside of the U.S., the income will be prorated based on the amount of time spent in each location.
 - iii. Effectively Connected Income (ECI) – A foreign entity that conducts a trade or business within the U.S. may claim that the payment is effectively connected with a U.S. trade or business by filing an IRS Form W-8ECI that contains a U.S. TIN. Although tax withholding is excluded on ECI, IRS Form 1042-S reporting is still required. An example of an entity that may have ECI is a foreign entity with an office in the U.S.
 - iv. Foreign Governments/Organizations – Tax withholding is excluded on most payments to the following: (1) foreign governments of a U.S. possession, (2) entities registered and accepted by the IRS as a tax-exempt organization and assigned a U.S. TIN, (3) entities that submit a letter from an attorney practicing in the U.S., attesting that the foreign entity would qualify as a tax-exempt organization if it applied with the IRS, and (4) international organizations (international organizations must be designated as such under the International Organizations Immunities Act and meet the definition of an international organization pursuant to [26 U.S.C. § 7701\(a\)\(18\)](#); examples include the following: the International Committee of the Red Cross, the United Nations, and the World Health Organization). The foreign government/organization must submit an IRS Form W-8EXP that contains a U.S. TIN.
- c. *Immigration Requirements* – In addition to determining whether tax withholding applies, it must also be determined whether nonresident aliens are eligible to receive payments from RCUH. See [Policy 2.012 Requirements When Paying Foreign Persons](#) for guidance regarding immigration requirements (certain visa types do not allow a nonresident alien individual to receive payments for services).
- d. *Required Documents* – Refer to [Policy 2.012 Requirements When Paying Foreign Persons](#) for detailed information on the forms and documentation that must accompany a payment request.
- i. Individuals – IRS Form W-8BEN (a UH Form WH-1 is also acceptable).
 - ii. Foreign Entities – The applicable IRS Form W-8BEN-E, W-8ECI, W-8EXP, or W-8IMY, or the RCUH Form 60, if applicable.
- e. *Taxpayer Identification Number* – Generally, a payment reported on an IRS Form 1042-S requires a U.S. TIN. Foreign entities that provide an IRS Form W-8BEN-E with a foreign taxpayer identification number do not require a U.S. TIN. Foreign entities that provide an IRS Form W-8ECI or IRS Form W-8EXP, require a U.S. TIN. When a reportable payment is made to a foreign vendor that does

not have a U.S. TIN but is required to have one, RCUH informs the vendor to apply for a U.S. individual taxpayer identification number (ITIN) (individuals who do not qualify for a social security number may file for an ITIN) or Federal Employer Identification Number (EIN), and to notify RCUH when the ITIN or EIN is received. Sample letters requesting that a vendor apply for an ITIN or EIN is provided in the [Sample Letters Requesting ITIN or EIN](#) . An IRS penalty of \$100 per return may be assessed by the IRS for forms with missing or incomplete information.

D. Tax Treatment of Third-Party Payments (Cash Advances)

1. Third-party compensatory payments are almost exclusively made for individual recipients rather than entities; thus, the following procedures focus on payments to individuals.
2. A third-party payment is any payment that is not paid directly to a recipient, such as when (1) a cash advance is given to a Principal Investigator or other authorized employee who in turn pays recipients cash or provides recipients with services or goods, or (2) another vendor is paid to provide services/goods (such as airline tickets, accommodations, food, etc.) to recipients. In the case of payments related to services, third-party *vendor* payments are generally only made for business expenses incurred by the service provider. It would be unusual for the payment for the service itself, to not be paid directly to the provider of the service. Thus, only cash advances are discussed in this policy. Refer to [Policy 2.008 Tax Treatment of Business Expenses \(Service-Related\)](#) for guidance when making third-party vendor payments for service-related business expenses.

When a third-party payment is made, the name and amount received by each individual recipient is not entered into the RCUH financial system, and no vendor record is established for the recipient. Although the recipient is not paid directly, all amounts received by the recipient must still be reported and/or withheld if applicable.

3. U.S. Citizens, Permanent Resident Aliens, and Resident Aliens

If a recipient receives a reportable payment (usually a \$600 or greater payment or cumulative payments (or \$10 or greater for royalties) during a calendar year), provide RCUH Accounting with the recipient's IRS Form W-9 (the UH Form WH-1 is required for resident aliens) and the amount paid at the time the recipient receives his/her payment(s) via the cash advance. Due to possible sensitive information in the IRS Form W-9/UH Form WH-1, it should either be sent in hardcopy, or sent via the UH File Drop system, at <https://www.hawaii.edu/filedrop/>, to mbrooks@rcuh.com.

4. Nonresident Aliens

- a. If a third-party payment is made for a nonresident alien, programs must perform the following additional tasks:
 - I. Identify the recipient's tax residency through the collection of the IRS Form W-8BEN (or UH Form WH-1);

- II. Perform tax withholding at the time of payment if required (alternatively, the payment can be grossed-up if the program chooses to do so (discussed in detail below); and
 - III. Submit a summary report (discussed in detail below) and each recipient's IRS Form W-8BEN to RCUH Accounting, so that the IRS Form 1042-S can be prepared.
- b. *Tax Withholding on a Cash Payment* – If a program makes a cash payment to a nonresident alien recipient using a cash advance allowance, the program must perform tax withholding, if required.
- I. For example, if a 30% tax withholding rate applies, a program must withhold \$30 from a \$100 payment, resulting in a \$70 payment to the recipient.
 - II. To pay the IRS the \$30, the program must initiate an Authorization for Payment (AFP), and submit the AFP form manually to RCUH Disbursing. Enter the name of the recipient and the formula used to determine the tax ($\$100 * 30\% = \30.00), and reference the source of the \$100 (such as the cash advance payment request number and check number) in the AFP form's description field. The tax payment for multiple payees can be made on one AFP form. Contact RCUH Disbursing if assistance is required.

Alternatively, if a program does not want to withhold any money from the payment, the program can gross-up the payment (essentially pay the tax for the nonresident alien recipient). The tax paid to the IRS when an amount is grossed-up is more than the amount that would have been withheld on a payment made to a recipient, because the total taxable amount includes the tax paid on behalf of the nonresident alien. The program must state the tax withholding rate and provide the name of the individual(s) and the dollar amount of the tax due to RCUH Disbursing, which will pay the vendor and the IRS. Contact RCUH Disbursing if assistance is required. The following is an example of grossing-up a \$100 payment at 30%:

(1) If \$100 is due to the recipient, divide \$100 by 70% (.70) = \$142.86

\$142.86 is the amount the program must pay.

\$100 is paid to the recipient, and

\$42.86 is the grossed-up tax paid to the IRS [30% of \$142.86].

- c. An IRS Form 1042-S requires a U.S. TIN. If a nonresident alien recipient does not have a TIN, the program must ask the recipient to apply for a U.S. individual taxpayer identification number (ITIN) and provide it to RCUH. A sample letter requesting that a recipient apply for an ITIN is provided in the Sample Letters Requesting ITIN or EIN. Contact RCUH Disbursing if assistance is required.

II. Relevant Documents

[Tax Treatment of Compensation \(Services, Rents, and Royalties\) Decision Tree](#)

[26 U.S.C. § 7701\(a\)\(18\)](#)

<https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z>

[Policy 2.008 Tax Treatment of Business Expenses \(Service-Related\)](#)

[Policy 2.011 Requirements When Paying U.S. Persons](#)

[Policy 2.012 Requirements When Paying Foreign Persons](#)

[Policy 2.204 Services Agreements](#)

[Policy 2.601 RCUH Employee Travel](#)

[Policy 2.702 Direct Vendor Payments \(AFP Form\)](#)

[Policy 2.703 Employee Business Expense Reimbursements \(AFP Form\)](#)

[Sample Letters Requesting ITIN or EIN](#)

[Expense Summary Tracking Sheet](#)

[Non-Employee Expense Payment Form](#)

[IRS Form W-9](#)

[UH Form WH-1](#)

[IRS Form 8233](#)

[IRS Form W-8BEN](#)

[IRS Form W-8BEN-E](#)

[IRS Form W-8ECI](#)

[IRS Form W-8EXP](#)

[IRS Form W-8IMY](#)

[RCUH Form 60](#)

Date Revised: 9/18/2017