

SCHOLARSHIPS, GRANTS, AND FOREIGN STUDENTS—TAX COMPLIANCE TIPS FOR U.S. INSTITUTIONS

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In recent years, record numbers of foreign students have enrolled in graduate and undergraduate programs at U.S. colleges and universities. During the 2012-2013 academic year, their numbers topped 800,000—the seventh consecutive annual increase.¹ Roughly two-thirds of such visiting students pay their own way or are otherwise subsidized from abroad, but their growing numbers mean that U.S. institutions will be awarding scholarships, grants, prizes and other forms of non-governmental assistance to foreign nationals with increasing frequency, and with all of the attendant tax compliance obligations that such payments entail.²

It should be noted at the outset that seemingly similar types of educational assistance may be subject to very different tax treatment regardless of the tax status of the recipient. For example, a scholarship may be excludable from income, taxable as wages, treated as non-wage income—or some combination of the above—depending on its terms. Moreover, the same types of assistance can be subject to very different reporting and withholding requirements, depending on whether the recipient is a U.S. citizen, a resident alien, or a nonresident alien, and on whether the recipient is eligible for any kind of relief under an applicable tax treaty.

It is imperative for U.S. colleges, universities, and other institutions offering educational assistance to understand—before payments are made—both (1) how the form of educational assistance they are offering is characterized for tax purposes and (2) how the recipient's tax res-

idence, visa status, and treaty eligibility can affect reporting and withholding obligations. Given the withholding requirements for payments to nonresident aliens, as well as potential exemptions and reduced withholding rates available for certain types of payments, it is easy to stumble into the trap of either under-withholding or over-withholding.

Residence status

U.S. citizens and resident aliens are subject to U.S. federal income taxes on their worldwide income, while nonresident aliens generally are taxed only on (1) their U.S.-source income and (2) income that is effectively connected with a U.S. trade or business (such as wages earned in the U.S.). Payments of U.S.-source “fixed or determinable, annual or periodic gains, profits or income” (FDAP) to nonresident aliens are subject to a 30% withholding rate on the gross amount paid, whether in cash or in kind.³ Lower rates apply for certain types of scholarships and grants. In contrast, non-wage payments to U.S. citizens and resident aliens generally are not subject to withholding, provided the payor obtains the necessary taxpayer identification information from the payee.⁴ Thus, a critical early step in awarding a grant, scholarship, or other payment or benefit to a foreign national is ascertaining the recipient's residence status.

An individual is considered a resident alien for U.S. federal income and employment tax purposes if he or she is a “lawful permanent resident” (green card holder) or satisfies the “substantial presence test” under Section 7701(b).⁵ With certain exceptions, if the sum of (1) an individual's days present in the U.S. during the

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current calendar year, (2) one third of his or her days present during the immediately preceding calendar year and (3) one sixth of his or her days present during the calendar year before that exceeds 183 days, he or she will be considered a U.S. resident under the substantial presence test.

There is an exception for visiting students, teachers, and trainees. Under Sections 7701(b)(3)(D) and (b)(5), a foreign student may be present in the U.S. for up to five calendar years on an F, J, M, or Q visa without being subject to the substantial presence test (thereby remaining a nonresident alien for federal income and employment tax purposes), provided he or she complies with visa requirements. Similarly, a foreign “teacher or trainee” (including visiting researchers, professors, physicians, summer camp workers, and other non-students) may be present in the U.S. on a J or Q visa up to two calendar years in a six-calendar-year period without having to count days present in the U.S. under the substantial presence test. The visiting student, teacher or trainee must file an IRS Form 8843 (“Statement for Exempt Individuals and Individuals

With a Medical Condition”) for each year for which this exemption is claimed.

With certain exceptions, a grantor generally must obtain a completed IRS Form W-8BEN (“Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)”) ⁶ from each foreign grantee, as well as a copy of the grantee’s F, J, M, or Q visa (as applicable), to verify the grantee’s foreign status and potential eligibility for a reduced withholding rate under the Code or a tax treaty. U.S. residence status (or citizenship) and taxpayer information generally is confirmed with an IRS Form W-9 (“Request for Taxpayer Identification Number and Certification”). ⁷ Grantors should be mindful of when a foreign grantee’s exemption period ends under the substantial presence test, as this could cause a change in residence status and applicable withholding and reporting requirements, depending on the grantee’s days present in the U.S.

Scholarships and fellowship grants

Scholarships and fellowship grants may be fully taxable, partially taxable, or entirely excluded from gross income, depending on their terms.

¹ See “Record Number of Foreign Students Flocking to U.S.,” Wall St. J., 11/11/13, available at online.wsj.com/news/articles/SB10001424052702304868404579190062164404756.

² Most forms of government-sponsored financial aid are available only to U.S. citizens and lawful permanent residents (green card holders).

³ Subject to certain exceptions, FDAP includes most U.S.-source income that is not effectively connected with a U.S. trade or business, such as dividends, interest, rents, royalties, and annuities, as well as payments to independent contractors. See Section 1441(b); Reg. 1.1441-2(b)(1).

⁴ Wages are subject to withholding at graduated rates for U.S. citizens, residents, and nonresidents alike, although fewer exemptions and allowances are available for nonresident aliens.

⁵ The substantial presence test is not determinative of an individual’s tax residence for gift and estate tax purposes.

⁶ Form W-8BEN was revised in February 2014. See www.irs.gov/formw8ben.

⁷ An IRS Form W-4 (“Employee’s Withholding Allowance Certificate”) generally would be obtained if the recipient is receiving wage compensation.

⁸ See Prop. Reg. 1.117-6(c)(2). Note that the 1988 proposed regulations reflect changes to the qualified scholarship provisions introduced subsequent to the final regulations by the Tax Reform Act of 1986, which significantly restricted the scope of scholarships and fellowship grants eligible for the exclusion. Although still in proposed form, the IRS regularly cites to them in letter rulings and other guidance.

⁹ See Reg. 1.117-3(b); Prop. Reg. 1.117-6(c)(4); Reg. 1.170A-9(c)(1).

¹⁰ For example, a museum offering limited fellowships or internships not otherwise affiliated with a degree program at a college or university likely would not satisfy this requirement. However, such activities might qualify if they are part of the core requirements for a degree program at an eligible college or university.

¹¹ See Reg. 1.117-3(e); Prop. Reg. 1.117-6(c)(5).

¹² See Notice 87-31, 1987-1 CB 475; Reg. 1.1441-2(b)(1)(i). Qualified scholarships and other items excluded from gross income under a provision of law without regard to the U.S. or foreign status of the owner are not FDAP and thus are not subject to nonresident alien withholding. Regs. 1.1441-2(b)(1)(i), -2(a). Similarly, only the taxable portion of a scholarship is reportable on Form 1042-S. See Reg. 1.1461-1(c)(2)(i)(K); Form 1042-S instructions.

¹³ See Reg. 1.117-3(c); Prop. Reg. 1.117-6(c)(3).

¹⁴ See Section 117(c); Notice 87-31; Regs. 1.1441-1(b)(4)(xvi), 1.6041-3(n).

¹⁵ See Reg. 1.6041-3(n).

¹⁶ This is confirmed in the instructions to IRS Form 1099-MISC (“Miscellaneous Income”), which note that compensatory scholarship or fellowship grants should be reported on Form W-2, while “[o]ther taxable scholarship or fellowship payments (to a degree or nondegree candidate) do not have to be reported by [the filer] to the IRS on any form.”

¹⁷ Note 12, *supra*. The Notice also confirms that unless Section 117(c) applies (i.e., the amount is compensatory), scholarships and fellowship grants (including any taxable portions thereof) are not subject to wage withholding, FICA taxes, or FUTA taxes.

¹⁸ The above withholding and reporting requirements would not apply to noncompensatory grants made to nonresident aliens from sources outside the U.S. (which generally would not be taxable in the U.S. in the first place). Additionally, otherwise U.S.-source grants made to nonresident alien individuals for study, research, or training outside the U.S. are characterized as foreign-source grants and thus are neither taxable to the recipients nor subject to withholding or reporting by U.S. grantors. See Reg. 1.863-1(d)(2).

¹⁹ Section 1441(b); Reg. 1.1441-1(b)(4)(xvi). Note that some amounts paid by foreign governments and organizations may be foreign source based on the payment arrangements and thus may not be subject to withholding taxes anyway.

Qualified scholarships. Section 117 excludes “qualified scholarships” from gross income regardless of whether the recipient is a U.S. citizen, resident alien, or nonresident alien. To be qualified, a scholarship or grant must be for qualified tuition and related expenses of a degree candidate at an educational institution.

Qualified expenses include tuition, matriculation fees, books, supplies, and equipment required for coursework. Room and board, travel costs, incidental expenses, equipment, and other academic or research-related expenses that are not required for enrollment, attendance, or fulfillment of mandatory coursework are not considered qualified expenses (and thus are taxable to the recipient).⁸ An “educational organization” is one that normally maintains a regular faculty and curriculum and has a regularly enrolled student body at the place where its educational activities are carried on (such as a primary or secondary school or a college or university).⁹ An organization engaged in both educational and non-educational activities is an educational organization for this purpose only if the non-educational activities are incidental to its educational mission.¹⁰ Finally, a candidate for a degree generally would include any primary or secondary school student, as well as any undergraduate or graduate student at a college or university, provided the scholarship award is for studies in furtherance of such student’s diploma or degree.¹¹ For example, a scholarship or grant covering tuition, room, and board for a degree candidate would not be a qualified scholarship with respect to the room and board, but could be a qualified scholarship with respect to the portion covering tuition and fees.

The portion of a scholarship or grant excluded from gross income as a qualified scholarship is not subject to reporting or withholding, regardless of whether the recipient is a U.S. citizen, resident alien, or nonresident alien.¹²

Taxable scholarships and fellowship grants (non-compensatory). Scholarships and grants in furtherance of the recipient’s studies or research are referred to in the regulations as “fellowship grants.”¹³ A fellowship grant (or any portion thereof) that does not satisfy the qualified scholarship requirements of Section 117 generally is taxable to the recipient as non-wage income. As discussed below, scholarships and grants (or any portions thereof) paid in consideration for services are ineligible for the qualified scholarship exclusion and are treated as wages for withholding and reporting purposes under the regulations.¹⁴

Withholding and reporting of taxable fellowship grants. Noncompensatory fellowship grants (other than qualified scholarships) are taxable to U.S. citizens, resident aliens, and nonresident aliens alike. Nonresident aliens, however, are subject to very different reporting and withholding requirements than U.S. citizens and resident aliens.

Reporting and withholding for U.S. citizen and resident alien grantees. Scholarships and fellowship grants paid to individuals are exempt from reporting on IRS Forms 1099 and W-2, whether or not such amounts are qualified scholarships, provided they do not represent payment for services within the meaning of Section 117(c) (for example, teaching, research, or other services provided as a condition of receiving the scholarship).¹⁵ Thus, if the recipient is a U.S. citizen or resident and the grant is noncompensatory, the payment is not reportable even if it is taxable to the recipient.¹⁶ Notice 87-31 nonetheless urges grantors to advise recipients on the taxability of their scholarships and grants.¹⁷

Grantors should obtain a completed Form W-9 from each recipient who is a U.S. citizen or resident in order to confirm U.S. status.

Reporting and withholding requirements for nonresident alien grantees. The taxable portion of a scholarship or fellowship grant paid by a U.S. institution or other U.S. grantor to a nonresident alien is subject to withholding and reporting under Sections 1441 and 1461, respectively.¹⁸ As noted above, a 30% withholding rate generally applies to payments of FDAP, whether in cash or in kind. However, in the case of nonresident alien recipients visiting the U.S. on F-1, J-1, M-1, Q-1, or Q-2 visas (e.g., students, teachers, trainees, and researchers), a rate of 14% applies to the taxable portion of any otherwise qualified scholarship that is not used for tuition or related expenses, as well as to the entirety of any scholarship or fellowship grant awarded to a nondegree candidate (for example, a postdoctoral fellow) by an exempt organization, a foreign government, an international organization, or a federal, state, or local government agency.¹⁹

Depending on the benefits offered to recipients, grantors potentially may find themselves required to withhold more in taxes than they are paying in cash. For example, a university offering a full tuition scholarship with free room and board may not make any cash payments to the recipient. If the recipient is a nonresident alien, however, withholding would be required at least with respect to the room and board (even if the tuition itself is excludable from income as a qual-

ified scholarship). Some institutions deal with this issue by “grossing up” the award with enough cash to cover the withholding taxes due (including withholding taxes payable with respect to the gross-up itself), but this can significantly increase the grantor’s costs.²⁰ A grantor making a cash-only grant would not face the same liquidity issue (although some grantors still consider grossing up such payments in order to make the grantee whole on an after-tax basis).

Grantors may be able to elect to apply an alternative withholding procedure with graduated withholding rates. The election is available for scholarships or fellowship grants paid

to nonresident alien grantees in F-1, J-1, M-1, Q-1, or Q-2 non-immigrant status (who also are eligible for the 14% rate).²¹ Under the alternate procedures, the grantor would withhold at the same graduated rates that apply to wages, but with limited allowances for the personal exemption amount and certain away-from-home expenses (as applicable).²² As noted on an IRS guidance page,²³ this can be a useful option for trainees on J-1 visas and others making short-term visits (under one year) to the U.S. when a large portion of the grant may consist of room, board, and travel reimbursements. Different documentation from the

²⁰ See Reg. 1.1441-3(f). For example, if a grantor wished to gross up in-kind benefits taxable at the 14% rate, it would need to divide the taxable benefit by 0.86 (1–0.14) and then multiply the resulting amount by 0.14 to determine the amount of income taxes that had to be remitted to the IRS.

²¹ See Reg. 1.1441-4(c)(2); Rev. Proc. 88-24, 1988-1 CB 800.

²² Amounts treated as wages for purposes of the alternate withholding procedures are not reclassified as wages for FICA or other purposes. Moreover, as discussed below, most nonresident aliens eligible for the reduced 14% rate or the alternate withholding procedures also would be exempt from FICA taxes on any portion of a scholarship or fellowship grant otherwise treated as compensation.

²³ “Withholding Federal Income Tax on Scholarships, Fellowships, and Grants Paid to Aliens,” available at www.irs.gov/Individuals/International-Taxpayers/Withholding-Federal-Income-Tax-on-Scholarships,-Fellowships,-and-Grants-Paid-to-Aliens.

²⁴ See discussion in note 12, *supra*.

²⁵ Reg. 1.1461-1(c); Form 1042-S instructions.

²⁶ Form 1042-S includes an entry for the applicable withholding rate. The Form’s instructions indicate that where multiple withholding rates apply to a specific type of income paid to a single recipient, a separate Form 1042-S must be filed for each rate. This arguably requires multiple Forms 1042-S where graduated rates are applied (although some filers enter a “blended” rate).

²⁷ As discussed above, visiting students may be present in the U.S. for up to five calendar years on an F, J, M, or Q visa without becoming residents for income tax purposes under the substantial presence test. Similarly, a visiting “teacher or trainee” may be present in the U.S. on a J or Q visa for up to two years during a six-year period without being subject to the substantial presence test. Thus, the grantee’s visa status may be determinative of both tax residence and eligibility for the reduced withholding rates.

²⁸ See Regs. 1.1441-4(c)(1), -6(b)(1). As discussed below, IRS Form 8233 (which must be filed) is used to claim treaty benefits with respect to compensation for personal services (including wages).

²⁹ Because there is no service requirement, taxable awards and prizes would not be considered wages.

³⁰ Payments of “fixed or determinable” income to an individual, partnership, or estate are reportable on an IRS Form 1099 information return if such payments total at least \$600 in a calendar year and are made in the course of the payer’s trade or business. See Section 6041(a); Reg. 1.6041-1(a)(1).

³¹ Note that achievement awards in recognition of activities conducted outside the U.S. are considered foreign source under Reg. 1.863-1(d)(2)(iii) and thus would not be subject to withholding or reporting if paid to a nonresident alien.

³² There could be situations in which a grantee might appropriately be characterized as an independent contractor for tax purposes, depending on the degree of financial, behavioral, and operational control over his or her day-to-day work and the particular arrangement with the grantor. See IRS Publi-

cation 15-A, *Employer’s Supplemental Tax Guide*, (discussing indicia of an independent contractor relationship). As discussed below, an independently conducted project grant generally would be taxed and reported as a payment to an independent contractor.

³³ See Reg. 1.117-4(c)(1); Prop. Reg. 1.117-6(d)(1). Reg. 1.117-4(c)(2) also includes services performed under the supervision of the grantor.

³⁴ See Reg. 1.117-4(c)(2); Prop. Reg. 1.117-6(d)(2).

³⁵ See Prop. Reg. 1.117-6(d)(1). See also 53 Fed. Reg. 21,688 (6/9/88).

³⁶ See Reg. 1.117-4(c)(2); Prop. Reg. 1.117-6(d)(2).

³⁷ See Reg. 1.117-4(c)(2).

³⁸ See, e.g., Prop. Reg. 1.117-6(d)(5), Example 3 (fellowship grant treated as wage compensation where the research project is determined by the grantor, the fellow is required to submit a paper describing the results, and the grantor retains rights to publish and otherwise use the results of the funded research); Rev. Rul. 72-263, 1972-1 CB 40 (post-doctoral research stipend deemed compensatory where the National Institutes of Health (NIH) retained a royalty-free license to any copyrighted material and patents to any inventions arising from the funded research because NIH was “bargaining for research services and a research product rather than seeking to primarily benefit the education and training of the recipient in his individual capacity”). But see Rev. Rul. 76-351, 1976-2 CB 34 (National Endowment for the Humanities grant excludable from income where no paper was required, no publishing rights were retained by the grantor, and the grantee was merely requested to provide a copy of any published paper to the grantor).

³⁹ In a pair of Chief Counsel Advice memoranda, the IRS considered grants provided to a state university hospital’s post-doctoral research fellows. Some grants were funded by a National Research Service Award (NRSA) program and some were funded from other sources. The NRSA grants were considered noncompensatory, while the non-NRSA grants were recharacterized by the IRS as wage compensation for income and employment tax purposes. The CCAs focused on the fact that the NRSA program was tailored to the grantees’ training and development, while non-NRSA grantees were required to perform specific services and pursue specific research projects selected by the hospital and evaluated based on their performance of such tasks (rather than their own training and development). The non-NRSA grantees also were subject to a much greater degree of day-to-day control over the conduct of their research and received retirement benefits and other fringe benefits indicative of an employer-employee relationship. The CCAs did not focus on intellectual property rights, but it is notable that the NRSA program (which was considered noncompensatory) allowed the government to retain a non-exclusive royalty-free license with respect to publications. However, the NRSA program did not give the government any patent rights and explicitly allowed grantees to copyright their own publications. See CCA 200944027, 10/30/09; CCA 201117026, 4/29/11.

grantee is required if the grantor elects to apply graduated rates.

As previously noted, the portion of any grant treated as a qualified scholarship is neither taxable to the recipient, reportable to the IRS, nor subject to withholding.²⁴ The rest of the grant (including benefits, such as room and board, that are provided in kind) must be reported to the IRS on Form 1042-S (“Foreign Person’s U.S. Source Income Subject to Withholding”) with a copy to the recipient, even if the grant is not subject to withholding because of an applicable treaty.²⁵ Aggregate amounts paid and withheld also must be reported on IRS Form 1042 (“Annual Withholding Tax Return for U.S. Source Income of Foreign Persons”). These forms are used for reporting purposes whether applying the “standard” (30% or 14% rate) or alternate (graduated) withholding rates.²⁶

If the grantor is using the standard withholding procedures (fixed 30% or 14% rate), it must obtain a completed Form W-8BEN from the grantee, as well as a copy of the grantee’s F, J, M, or Q visa (as applicable) to determine both the tax residence of the grantee and the grantee’s eligibility for the reduced 14% rate (if applicable).²⁷ Grantors may wish to confirm that grantees have filed or will file Form 8843.

Form W-8BEN also is used to certify the grantee’s eligibility for a reduced rate or exemption under a treaty. Form W-8BEN is not filed with the IRS, but the grantor must keep the completed form in its files and make it available to the IRS upon request.²⁸

If the grantor is applying the alternate procedures (graduated rates), it must instead obtain a completed Form W-4 from the grantee. The same visa and residence considerations as described above would apply.

Awards and prizes. If a scholarship recipient or grantee is not required to use the funds in furtherance of his or her studies or research (including for room, board, and other related expenses) the “scholarship” is includable in the recipient’s gross income as a taxable award or prize.²⁹

The reporting exception for scholarships and fellowship grants in Reg. 1.6041-3(n) does not apply to awards and prizes. Thus, the full amount of any award or prize given to a U.S. citizen or resident must be reported on Form 1099-MISC if the total payments are at least \$600 in a calendar year.³⁰

As for nonresident aliens, neither the 14% withholding rate nor the alternate withholding procedures (graduated rates) for fellowship

grants paid to eligible recipients on F, J, M, and Q visas would apply to awards and prizes. Thus, the full amount of any award or prize paid by a U.S. grantor to a nonresident alien generally will be subject to withholding at a 30% rate unless a treaty exemption is available.³¹ These amounts are reportable on Forms 1042 and 1042-S.

Amounts paid in consideration for services

Scholarships and grants awarded in consideration for services performed by the grantee generally are taxable wages subject to the same wage withholding rules as other employment arrangements.³²

When scholarship and grant payments are compensatory. As previously noted, the income exclusion for qualified scholarships (and qualified tuition reductions) under Section 117 does not apply to any portion of a scholarship or grant that represents payment for teaching, research, or other services performed by the recipient as a condition of receiving the scholarship or grant.³³ Under both the final and proposed regulations, a scholarship or grant will be considered to represent payment for services if the research or studies supported by the scholarship or grant are primarily for the benefit of the grantor, rather than the recipient.³⁴ The proposed regulations take this position even where such services are required of all degree candidates as a condition of receiving a degree.³⁵ Periodic reports to keep the grantor informed of the recipient’s general progress are not considered services performed for purposes of Section 117(c), however.³⁶

A purely incidental benefit to the grantor will not cause a scholarship or fellowship grant to be considered compensatory.³⁷ However, where the benefit to the grantor is more than incidental and suggests a quid pro quo—for example, where the grantor retains publishing or other intellectual property rights in the results of the funded activities—the IRS may take the position that the scholarship or grant is compensation.³⁸ Recent informal guidance could be read to suggest that the retention of limited publishing rights by the grantor is not necessarily fatal, but grantors should proceed with caution in this area.³⁹

Partially compensatory scholarships and grants. A scholarship or fellowship grant may be in part compensatory and in part in furtherance of the recipient’s research or studies. When a portion of a scholarship or grant is given in consideration for services, the grantor must make a good-faith allocation to determine the com-

pensatory portion based on all of the facts and circumstances. Notice 87-31 and Prop. Reg. 1.117-6(d)(2) identify three non-exclusive factors to consider: (1) compensation paid by the grantor for similar services performed by students with qualifications comparable to those of the recipient, but who do not receive scholarships or grants; (2) compensation paid by the grantor for similar services performed by full-time or part-time employees of the grantor who are not students; and (3) compensation paid by other educational organizations for similar services performed either by students or other employees. Given the different tax treatment of the compensatory portion, granting institutions would be wise to establish and document the allocation between the service-related and “scholarship” portions of a grant early in the process.⁴⁰

Wage withholding and reporting for service-related grants Prop. Reg. 1.117-6(d)(4) and Notice 87-31 provide that any portion of a scholarship or fellowship grant that represents payment for services is considered wage compensation for wage withholding and reporting purposes, as well as for FICA and FUTA purposes (as applicable). Such amounts also may be subject to wage withholding

and employment taxes at the state level.⁴¹ Subject to certain modifications, normal wage withholding rules apply to wage compensation paid to U.S. citizens, residents, and nonresident aliens alike, although nonresident aliens (and in some cases resident aliens) may be eligible for reduced withholding rates or an outright exemption under an applicable treaty.⁴² Note that a 30% withholding rate applies under Section 1441(a) to compensation paid to a nonresident alien as an independent contractor (e.g., an honorarium for a visiting lecturer) absent an applicable treaty exemption.

Taxable wages generally are reportable on Form W-2. However, certain types of wage payments are reportable on Form 1042-S, rather than on Form W-2, when paid to a nonresident alien. For example, the taxable portion of any scholarship or fellowship grant—including any such amount representing payment for services—is reportable on Form 1042-S (and Form 1042).⁴³ Thus, the compensatory portion (if any) of a scholarship or fellowship grant is reportable on Form W-2 if paid to a U.S. citizen or resident and on Form 1042-S (and Form 1042) if paid to a nonresident alien. Wages paid to a nonresident alien also must be reported on Forms 1042-S and 1042 (whether or not paid in connection

⁴⁰ Grantors may need to consider not only taxes, but also minimum wage requirements and other labor laws in determining how much of the grant should be treated as compensation.

⁴¹ Note that Section 501(c)(3) organizations (including many schools) are exempt from FUTA taxes, but may be subject to state-level unemployment insurance requirements. See Section 3306(c)(8).

⁴² Nonresident aliens generally cannot claim as many exemptions or allowances as U.S. citizens and residents and thus are subject to special withholding rates. See IRS Publication 15, “(Circular E), Employer’s Tax Guide.”

⁴³ Reg. 1.1441-1(b)(4)(vi) (citing former Reg. 1.6041-3(o)), provides that the compensatory portion of a scholarship or grant is reportable as wage income. Reg. 1.6041-3(n) (formerly Reg. 1.6041-3(o)) provides that any portion of a scholarship or fellowship grant that represents payment for services within the meaning of Section 117(c) must be reported as wages on Form W-2, but refers the reader to Reg. 1.1461-1(c) for “applicable reporting requirements for amounts paid to foreign persons.” Reg. 1.1461-1(c)(2)(i)(K) goes on to require reporting on Forms 1042-S and 1042 for any “[s]cholarship, fellowship, or grant income and compensation for personal services that is not excludable from gross income under section 117 (whether or not the taxable scholarship, fellowship, grant income, or compensation for personal services is exempt from tax under an income tax treaty) paid to foreign students, trainees, teachers, or researchers.” Thus, although such amounts are treated as wages for withholding tax purposes, they nonetheless are reported on Form 1042-S, rather than on Form W-2.

⁴⁴ If only a portion of the recipient’s wages is exempt from withholding taxes under a treaty (e.g., because the total compensation paid exceeds the exemption limit under the treaty), the exempt portion is reportable on Form 1042-S (and Form 1042), while the non-exempt portion is reportable on Form W-2. See IRS Publication 515, “Withholding of Tax on Nonresident Aliens and Foreign Entities.”

⁴⁵ See Reg. 1.1441-4(c)(1); Form 8233 instructions. Although Form W-8BEN is used for noncompensatory payments, a grantee claiming treaty benefits with respect to both compensatory and noncompensatory payments from the same grantor (for example, a taxable scholarship and wages from on-campus employment) would file Form 8233 jointly with the grantor for both types of income.

⁴⁶ Section 3121(b)(19).

⁴⁷ Reg. 31.3121(b)(19)-1(a)(1).

⁴⁸ There may be limited situations in which a visiting teacher or trainee is exempt from Social Security (but not Medicare) taxes under an international totalization agreement, but in most cases in which the grantor is a U.S. institution, Social Security taxes will apply absent another exemption. For additional information on Social Security totalization agreements, see “U.S. International Social Security Agreements,” available at www.ssa.gov/international/agreements_overview.html.

⁴⁹ Additional requirements apply. As previously noted, tax-exempt organizations generally are exempt from FUTA taxes, but may be subject to unemployment insurance regimes at the state level.

⁵⁰ Additional requirements and a safe harbor are laid out in Reg. 31.3121(b)(10)-2 and Rev. Proc. 2005-11, 2005-2 IRB 307, respectively.

⁵¹ Payments for services performed outside the U.S. are not reportable on Form 1099-MISC if it is reasonable to believe that such amounts will be excluded from gross under the foreign earned income exclusion provisions of Section 911 and the regulations thereunder. See Reg. 1.6041-3(e).

⁵² Payments for services performed abroad by a nonresident alien generally are neither taxable nor reportable in the U.S.

⁵³ Most treaties do not cover FICA taxes. As discussed in note 48, *supra*, a Social Security totalization might apply in certain limited cases.

⁵⁴ A breakdown of treaty benefits by country can be found in IRS Publication 901, *U.S. Tax Treaties*.

with a scholarship) if the recipient is claiming an exemption under a treaty.⁴⁴ Note, however, that wages paid to a student employee other than in connection with a scholarship or fellowship grant still are reported on Form W-2 unless the student is claiming a treaty exemption.

Generally, an individual receiving wage payments must furnish a Form W-4 to the payor (which the payor must keep on file) whether the recipient is a U.S. citizen, resident, or nonresident alien. The same visa documentation discussed previously is required in order to ascertain residence. If the recipient is claiming a reduced withholding rate or exemption with respect to compensation under a tax treaty, the payor and recipient must jointly file Form 8233 (“Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual”) with the IRS.⁴⁵

FICA and FUTA taxes and applicable exemptions. U.S. citizens, residents, and nonresident aliens alike generally are subject to FICA taxes on wages earned in the U.S. There is an exception, however, for nonresident students, scholars, professors, teachers, trainees, researchers, physicians, au pairs, summer camp workers, and other aliens temporarily present in the U.S. on F-1, J-1, M-1, Q-1, or Q-2 non-immigrant visas. These individuals are exempt from FICA taxes on wages paid to them for services performed in the U.S. as long as (1) such services are allowed by U.S. Citizenship and Immigration Services (USCIS) for their respective non-immigrant visa statuses and (2) such services are performed to carry out the purposes for which such visas were issued.⁴⁶ Thus, many nonresident aliens who receive paid internships or service-related grants will be subject to wage withholding, but not necessarily to FICA taxes. Aliens present on the above visas are presumed to be nonresident aliens for this purpose as long as such presumption is consistent with the residency rules of Section 7701(b).⁴⁷ Once such an individual becomes a resident alien for tax purposes, however (for example, a student who remains in the U.S. past the five-year exemption period for visiting students and becomes a resident under the substantial presence test), he or she will no longer be eligible for this FICA exemption.⁴⁸

There also are student FICA and FUTA exemptions under Sections 3121(b)(10) and 3306(c)(10)(B) for services performed in the employ of a school, college, or university if such services are performed by a student who regularly attends classes at that institution.⁴⁹ These

exemptions apply without regard to the citizenship or tax residence of the student. Thus, they could cover U.S. citizens, green card holders, and foreign students who have become resident aliens under the substantial presence test.⁵⁰

Project grants

Project grants are grants made to support specific activities or projects that are consistent with a tax-exempt organization’s exempt purpose. They are not made in furtherance of an individual’s studies or academic research or for the granting organization’s direct benefit.

Project grants generally are reported as payments to independent contractors (regardless of whether the grantee otherwise meets the IRS tests for independent contractor status). Thus, project grants paid to U.S. citizens or residents are reportable on Form 1099-MISC if the amounts exceed \$600 in a calendar year, but they are not subject to withholding if the recipient furnishes a completed Form W-9.⁵¹ Project grants are reportable on Form 1042-S (and Form 1042) and subject to a 30% withholding rate under Section 1441(a) if paid to a nonresident alien unless a treaty exemption is available.⁵²

Overview of selected treaty exemptions

Many bilateral income tax treaties between the U.S. and other treaty countries include articles exempting payments to or on behalf of visiting students, teachers, and trainees from federal income taxes.⁵³ Some of these provisions are limited to tuition and support payments for visiting students, while others also cover ancillary compensation arrangements, as well as grants and stipends for visiting scholars, professors, researchers, and trainees.⁵⁴ The determination of a particular grantee’s treaty eligibility requires a careful consideration of his or her circumstances.

Exemptions for students and trainees. Most U.S. tax treaties provide some type of exemption for payments from abroad with respect to the education, training, and maintenance of students temporarily visiting the U.S. from a treaty country. Coverage can vary significantly from treaty to treaty. Some treaties (such as the U.S. income tax treaties with Mexico, Switzerland, South Africa, and the United Kingdom) do not cover education and support payments from U.S. grantors. Others (e.g., those with China, France, Germany, Israel, the Netherlands, Poland, and South Korea) are quite broad, exempting grants and scholarships

from nonprofit religious, charitable, scientific, literary, or educational organizations without regard to source.⁵⁵

Scholarships and grants from foreign sources generally are not taxable to nonresident aliens, so treaty exemptions limited to foreign source aid will be of limited use to students visiting from abroad who are within their exemption periods under the substantial presence test (and thus are still nonresidents).⁵⁶ For example, a student from South Africa would have no relief under the U.S.-South Africa tax treaty with respect to a scholarship from a U.S. institution (although the portion covering tuition might nonetheless be excluded from income under Section 117) and may not have any use for the treaty's limited exemption for scholarships and grants from foreign sources while he or she remains a nonresident alien under the substantial presence test. In contrast, an eligible student from South Korea could receive a "full ride" from a U.S. college covering tuition, fees, room, board, and travel expenses for up to five years and would be exempt from U.S. income taxes on the entire amount under Article 21 of the U.S.-South Korea tax treaty.⁵⁷

Note that there are some situations in which an exemption for foreign source grants might be helpful to the grantee. For example, depending on the laws of the state in which studies are pursued, a nonresident alien could become a resident for state income tax purposes during his or her exemption period (even while remaining a nonresident alien for federal income tax purposes under the substantial presence test), thereby becoming subject to state income taxes on worldwide income. A treaty exemp-

tion for foreign source grants could reduce or eliminate such student's state income tax liabilities.⁵⁸ There also could be situations in which a student, trainee, or other visitor becomes a U.S. resident under the substantial presence test (e.g., because he or she stays in the U.S. past the applicable exemption period or is not otherwise an "exempt individual") and thus might need a foreign source exemption for federal income tax purposes, although in many cases the treaty exemption might not extend past the exemption period under the substantial presence test anyway.⁵⁹

Some treaties also exempt associated compensation paid to visiting students, usually up to a given threshold—for example, up to \$5,000/year for students under the U.S.-China tax treaty and up to \$9,000/year under the U.S.-Germany tax treaty. These ancillary service exemptions are more common in treaties with developing countries, but also are included in the tax treaties with Germany, the Netherlands, and Israel.⁶⁰

Tax treaties with countries across the development spectrum (Egypt, France, Germany, Iceland, Israel, Lithuania, the Slovakia, Spain, and Thailand, among others) include separate exemptions—often with higher thresholds—for business apprentices and trainees. The apprentice and trainee exemptions often require that the employer be a resident or enterprise of the same (non-host) state as the trainee. Most student and trainee exemptions are time-limited, but time limits vary significantly, depending on when the treaties were enacted. The 1996 Model Treaty and the 2006 Model Treaty both limit this exemption to one year.

⁵⁵ Both the United States Model Income Tax Convention of November 15, 2006 (the "2006 Model Treaty") and the United States Model Income Tax Convention of September 20, 1996 (the "1996 Model Treaty") limit the scholarship exemption to scholarships and grants from foreign sources.

⁵⁶ Before the substantial presence test was introduced, along with its two-year and five-year exemption periods for visiting students, teachers, and trainees, it was much more common for visiting students to become resident aliens during their studies under the prevailing residence tests (and thus taxable in the U.S. on their worldwide income), so treaty exemptions for foreign source aid were much more relevant. See Kepley, *Nonresident Alien Tax Compliance: A Guide for Institutions Making Payments to Foreign Students, Scholars, Employees, and Other International Visitors*, Volume One (Arctic International LLC, 2011), at 154-155.

⁵⁷ Again, the tuition and fees may be excluded from income under Section 117 anyway.

⁵⁸ Note that most income tax treaties do not cover state and local taxes. However, many states use federal taxable income as a starting point without adding back amounts excluded by treaty (and some explicitly honor treaty exemptions).

⁵⁹ Eligibility for these exemptions generally is based on the recipient's status as a resident of the other treaty country *immediately prior* to arrival in the U.S. A savings clause (for example, Article 1(5)(b) in the U.S.-Germany income tax treaty) then treats the recipient as a resident of the other treaty country (and not the host country) in order to preserve eligibility for treaty benefits.

⁶⁰ The Treasury Department's technical explanation accompanying the U.S.-Netherlands tax treaty explains: "It is not standard U.S. treaty policy, particularly in treaties with developed countries, to include an earned income exemption for visiting students. This provision was agreed to in this treaty because it was important to the Netherlands government, and essentially does no more than retain a provision from the prior Convention." "Netherlands Technical Explanation," available at www.irs.gov/Businesses/International-Businesses/Netherlands-Technical-Explanation.

⁶¹ Some newer U.S. tax treaties have eliminated the separate article for independent personal services and instead address payments to independent contractors under the business profits article. For example, the independent personal services article was eliminated from the tax treaty with the United Kingdom when the treaty was replaced in 2001.

Professors and teachers. Many treaties include provisions (often in separate articles from the student and trainee provisions) exempting the pay of visiting teachers and professors for periods of up to two or three years if they visit the U.S. to teach or conduct research. The exemptions for visiting professors, teachers, and researchers generally are not limited to foreign source payments, as such payments frequently are made by the host country institution at which the professor, teacher, or researcher will be teaching or performing research. The applicable exemption period generally commences on the date of arrival in the U.S. for the purpose of the covered teaching or research activities. In most cases, the exemption applies even if the individual's stay in the U.S. extends past the applicable two-year or three-year exemption period, but there are notable exceptions. For example, if the individual's visit to the U.S. is longer than two years, then the exemption may be lost retroactively for the entire visit (unless the tax authorities agree otherwise) under the U.S. tax treaties with India, Luxembourg, the Netherlands, and the United Kingdom.

Almost all teaching and research exemptions require that the covered research serve a public interest and not be carried on mainly for any person's private benefit. Some also require that the person be invited by a federal, state, or local government agency or a "recognized educational institution" in the host country, although this second requirement is not included in most recently amended treaties, such as those with the United Kingdom, France, and Germany. Additionally, some treaties (for ex-

ample, the treaties with France, Israel, and the Netherlands) do not allow an individual to claim the exemption for students and trainees and the exemption for teachers, professors, and researchers in successive periods or within a set number of years.

Other treaty exemptions Where an individual receives compensatory amounts that are not covered by the student/trainee or teacher/professor exemptions under the applicable treaty, consideration should be given to the potential application of other treaty exemptions, such as for dependent personal services (employment compensation), independent personal services (independent contractor compensation), and business profits (which also can cover independent contractor payments).⁶¹

Conclusion

As discussed above, grantors making payments or providing other benefits to students, teachers, and trainees visiting from abroad will want to be proactive in ascertaining the recipient's residence and visa status well before any cash or non-cash benefits are awarded. Grantors will need to consider not only eligibility for exemptions or reduced rates under the Code and applicable treaties, but also cash flow planning if taxes will have to be withheld for in-kind benefits. Early communication and coordination with the grantee is critical to ensuring that neither the grantor nor the grantee misses an opportunity for tax relief and that neither faces unexpected liabilities or liquidity issues down the road. ■