Cross-Border Services and Employment Tax Issues

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Employer Considerations
Overview

- Having the right people on the ground is critical to your company’s success, regardless of international boundary. Without proper planning, international assignments often lead to compliance issues and unnecessary costs for the employer. The challenges are real for any company with employees overseas, regardless of whether you have a couple of employees or a couple hundred employees.

- U.S. Citizens on international assignments remain subject to the full force and effect of U.S. tax reporting and payment requirements and may also be subject to the host country’s employment taxes. It can be a struggle to find ways to equalize these tax expenses so that employees are not unfairly burdened without driving the cost of international assignments too high.

- Companies with employees taking assignments in the U.S. are often challenged to understand the nuances of U.S. tax laws.
Payroll and Compensation

- U.S. individual is still subject to US payroll taxes (including Social Security and Medicare)

- Income tax withholding is generally based on the estimated liability after considering eligibility for the Foreign Earned Income Exclusion and Foreign Tax Credit

- When an individual is on a long-term foreign assignment, costs may be 2 to 3 times larger than if employee remained in the US

- When an individual is on a short-term foreign assignment, only certain items are taxable and included in W-2
Absent the Totalization Agreement, the employee is required to pay Social Security taxes to both countries for the same work.

Under the Totalization Agreement, employee typically will continue to pay only US Social Security taxes.

Home country employer will need to apply for a Certificate of Coverage.

In the application, it is indicated that the individual will remain an employee of the US company while employed with the foreign affiliate.
## Totalization Agreements with US

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Secondment Agreement/Dual Employment Agreement

- Used to maintain an individual’s employment status with the US company while providing services to a foreign company

- US company pays employee and withholds the appropriate taxes and then charges the foreign company for the salary of the employee (charge foreign company at cost and provide adequate transfer pricing documentation)

- Legal agreement between the employer and the employee which documents and clarifies the employment arrangement
Tax Equalization

- Purpose: typically designed to treat the employee as fairly and equitably as possible during foreign assignment from a tax perspective
  - Keeps employee at neutral position so that assignee pays no more or no less tax than as if they stayed in the US
  - Promotes mobility within the Company
  - Provides competitive pay package
  - Allows better compliance with home and host tax law
  - Company pays all foreign taxes
  - Employee subject to hypothetical withholding
Hypothetical Tax Withholding

- **Hypothetical Tax**
  - Employee bears the economic burden of US tax on those items of wages which are compensatory (rather than allowances for foreign costs)
  - Expatriate employees will be responsible for a hypothetical US federal and state tax liability on their company and non-company income as though they had remained in the US
  - This hypothetical tax represents the cost that the expatriate must “pay” regardless of their actual US or host country tax liabilities
  - Actual liabilities will be paid on the expatriate’s behalf, or reimbursed to the expatriate, by the employer
The final tax equalization settlement is the reconciliation between the employee’s hypothetical federal and state tax liability and the taxes actually paid by the employee.

The final hypothetical tax liability will reflect all applicable US tax provisions.
Tax Protection

- If actual worldwide taxes are lower than the stay at home tax, employee receives savings as a tax windfall.

- If actual worldwide taxes are higher than stay at home tax, excess tax burden is reimbursed.

- Employee usually pays all actual taxes.

- No hypothetical withholding is charged.

- Company reimburses any excess tax after returns are filed.
U.S. Individual Considerations
Individuals working abroad

Expatriates
- US citizen or a US resident alien living/working in a foreign country are subject to the same US income tax laws as full year tax residents
- Likely also taxable in the foreign country in which the individual resides

Inpatriates
- Foreign nationals working and residing in the US
- Full year resident aliens taxed like US citizens and US residents
- Non-resident aliens taxed on Effectively Connected Income
- Special elections available with regards to resident status
- Tax treaty to determine residency
Taxpayer/Employee Considerations

- Foreign Earned Income Exclusion
- Foreign Housing Deduction/Exclusion
- Foreign Tax Credit/Deduction
- Other Issues
Foreign Earned Income Exclusion

- Tax home test:
  - Tax home must be in a foreign country, or countries, throughout the period of bona fide residence or physical presence
  - Tax home is the regular or principal place of business and employment, regardless of where the individual maintains their family
  - A tax home is where the taxpayer is permanently or indefinitely engaged to work. Having a tax home in a given location does not necessarily mean that given location is your residence for tax purposes

- Increased IRS scrutiny/audit activity regarding Sec. 911 exclusions

- Maximum exclusion for 2014: $99,200; 2015: $100,800
Foreign Earned Income Exclusion

- **Bona Fide Residence Test (BFR)**
  - Applicable to US citizens and Green Card holders of certain treaty countries
  - Must be resident of foreign country
  - Period of bona fide residence should include an entire calendar year
  - Form 2350

- **Physical Presence Test (PPT)**
  - Applicable to US citizens and Green Card holders of certain treaty countries
  - Must be physically present in a foreign country for 330 days in a rolling 365 day period
  - Form 2350
Foreign Housing Exclusion/Deduction

- **Foreign Housing Exclusion**
  - Applicable to an employee

- **Foreign Housing Deduction**
  - Applicable to self-employed individuals

- **Base Housing Amount**
  - 16% of Foreign Earned Income Exclusion
  - Limited to number of qualifying days during tax year
  - Base housing amount for 2013: $15,616; 2014: $15,872

- **Maximum Exclusion**
  - Limited to number of qualifying days during tax year
A Foreign Tax Credit is available to avoid/minimize double taxation of income in the US and a foreign country.

The available Foreign Tax Credit is determined in part by a taxpayer’s foreign source income.

Wages are sourced between US and foreign sources based on the days spent providing services in each country.

The Foreign Tax Credit may not be taken on income that is excluded under the Foreign Earned Income or Housing Exclusions.

Any unused amounts of Foreign Tax Credit should be carried back to the previous tax year and then carried forward for up to ten years.
Income Sourcing – FEIE & FTC

Location of Services Performed
- Base salary
- Bonus
- Cost of living adjustment
- Equity income (stock options)
- Vacation pay

Geographical
- Education reimbursement
- Foreign taxes
- Hardship premium
- Housing costs
- Moving expenses
- Transportation costs
Reduction of Foreign Taxes

- If an individual takes FEIE, the amount of foreign taxes paid or accrued should be reduced.
- If only part of the individual's foreign earned income is excluded, the amount of tax allocable to the excluded income should be determined.

Reduction Amount = \frac{\text{Foreign Taxes Paid/Accrued}}{\text{Foreign Earned Income and Housing Exclusion}}

\text{Income earned on foreign assignment + other income earned on foreign assignment}
Foreign Tax Credit vs. Foreign Earned Income Exclusion

- In some cases, it may be more advantageous to claim the Foreign Tax Credit alone
- State tax considerations
State Tax Considerations

- State residency status generally needs to be considered on a case by case basis
- Individual may need to file nonresident state tax returns to report rental of primary home while on foreign assignment
- Most states allow Foreign Earned Income Exclusion
- Few states allow Foreign Tax Credit
Taxpayer/Employee Considerations

- **Other Issues**
  - Form 8938
  - FBAR (FinCEN Form 114)
  - Form 3520
  - Foreign Pensions
  - Form 8621
Non-U.S. Individual Considerations
Foreign National Overview

- Residency Status
- Taxation of Resident
- Taxation of Nonresident
- ITIN Procedures
Filing Status

- Full Year Resident
  - Filing status: Single, MFJ, MFS, HOH, QW

- Non-resident
  - Filing status: Single, Married filing separate

- Dual Status (Part year resident)
  - Occurs in the year of arrival or departure
  - Filing status: Single, Married filing separate
Resident Alien Taxation

- **Filing Status:** Single, MFJ, MFS, HOH, QW
- **Exemptions:** Self, Spouse, Qualifying Dependents
- **Income:** Worldwide income from all sources with exception of special items exempt from tax by domestic statute (example: interest from municipal bonds)
- **Deductions:** Above the line adjustments & Schedule A Itemized deductions
- **Credit:** Foreign tax credit, child care credit, child tax credit, education credits, etc.
Non-Resident Taxation

- Exemptions:
  - Self
  - Exceptions: Resident of Canada, Mexico, or South Korea or U.S. national
  - Total exemptions cannot exceed the taxpayer’s US source effectively connected income
Residency Status

- Residency Tests:
  - Lawful Permanent Residence Test (Green Card Test
  - Substantial Presence Test
    • Present in the US at least 31 days during the current year, and
    • If the sum of:
      - total current year days +
      - 1/3 of first preceding year +
      - 1/6 of second preceding year
      - = >183 days
Residency Period

- **General Rule:**
  - **Starting Date = first day in US**
    - First day of presence in US while lawful permanent resident
    - First day of presence in the US during the year, if individual meets SPT
  - **Termination date = last day in US**
    - Last day individual has lawful permanent residence status
    - Last day of presence in the US during year if not a US resident alien at any time in succeeding calendar year and during non-resident period has a closer connection to foreign country
Residency Period

- Days of presence in US ignored for purposes of SPT test if:
  - A person temporarily present in US because of full time employment by a foreign government in a diplomatic or consular status or by an international organization
  - Teacher or trainee temporarily in the US with a J-visa, unless the individual was exempt as a teacher, trainee or student for any portion of two of the preceding six calendar years
  - A student temporarily present in US with F, J or M Visa
  - Certain professional athletes (generally only if competing in charitable event)
Residency Period

- Tax Treaty “Tie Breaker” Rules
  - Individual may be considered a resident of both the US and home country under domestic law. Treaty tie breaker rules examine the following:
    - Individuals permanent home is considered
    - Habitual abode
    - Country in which he is a national

- If none of these determine the tax residency then the competent authorities of the countries will make the determination by mutual agreement
Residency Period

- Closer Connection Exception
  - The following must occur:
    • Must be a foreign national (or NRA)
    • Meet SPT
    • Present in US at least 31 days, but less than 183 days during current year
    • Must have a tax home in foreign country to which the individual has closer connection than to the US
  - Factors to determine Closer Connection include (but are not limited to)
    • Maintain Primary Residence
    • Financial Interests
    • Family
    • Social Contacts
Residency Period

- **No Lapse Rule**
  - Taxpayer is resident at any part of the preceding year
    - Taxed as a resident at the beginning of the current year
  - Taxpayer is a resident at any part of following year
    - Taxed as a resident at the end of current year
Special Elections

- First Year Election – Section 7701(b)
- Joint return elections for married taxpayers
  - 6013(g) election
  - 6013(h) election
Special Elections

- Section 7701(b) Election
  - 1st Year Election
  - If satisfied – turns a full-year Nonresident in to a dual status taxpayer.
  - How to qualify:
    - Prior year must be nonresident
    - Next year must pass substantial presence test
    - Current year must be present in US for at least 31 days in a row and have been in the US for at least 75% of the days between the first day of that 31 day period and the last day of the year.
    - Residency then starts on the first day of the earliest 31-day period.
Special Elections

- Section 6013(h) Election
  - Makes dual status married individuals into full year resident taxpayers
  - Individuals must be a nonresident at the start of the year and individual must be a resident at the end of the year and be married to US citizen, green card holder or resident at the end of the year
  - One time election, can never be made again (even if spouses divorce), applies to current year only
  - Both spouses file election
Special Elections

- **Section 6013(g) Election**
  - Makes nonresident married individuals into full year resident individuals (It also will make the other spouse a full year resident if he or she was an arriving dual status)
  - Individual must be a non-resident at the end of the year who is married to a US citizen, green card holder or resident at the end of the year
  - One time election (can never be made again) for current year and all subsequent years
Nonresident Alien Tax Rates

- US Employment Income - Graduated Rates
- US Passive Income (other than interest)
  - Flat 30%
  - Treaty rate (example 15%)
  - Withholding
- Interest – In general, no tax per section 871
- US Real Estate Gains – Graduated Rates
- US Investment Gains – Generally not taxable
Sourcing Rules

- Personal services (e.g., wages) – where performed
- Interest & dividends – residence of payor
- Rents & royalties – location of the property
- Gain from sale of securities – residence of seller
- Gain from sale of real property – location of property
ITIN Application Procedures

- Must either mail original passport or other acceptable documents (or certified copies of these documents obtained from the original issuing agency) to the IRS Service Center.

- Even if using a Certifying Acceptance Agent (CAA), taxpayers must still mail either original documents or copies certified by the issuing agency to the IRS.
Importance of Tax Treaties
Income Tax Treaties

- **What are they?**
  - A bi-lateral agreement between two countries

- **Purpose**
  - Promote commerce by reducing or eliminating double tax
  - Define or establish “nexus” or Permanent Establishment (PE)
  - Define taxability for individuals of certain income producing activities in other jurisdictions
  - Reduce rates of withholding and other taxes

- **If no treaty, treatment defaults to local law**

- **U.S. Model Treaty**
  - Provides model for form and structure of negotiations
  - Individual treaties may have similarities and differences

- **Discussion in following slides based upon US-UK treaty**
Income Tax Treaty - Residence

- Generally Article 4 of Treaty

- Establishes guidelines to determine the appropriate tax residence of an individual, business, or organization

- Provides residency tiebreaker procedures in cases where an individual is a resident of both states. Considerations include:
  - Centre of vital interests
  - Habitual abode
  - Nationality
  - Competent authority determination

- Saving Clause
Income Tax Treaty - Reduced Rates

- **Reduced Rates**
  - 0% to 15%

- **Types of income**
  - Interest income
  - Dividend income
  - Royalties
  - Branch profits tax

- **Certification**
  - Often proof is required that payment is eligible for reduced withholding
  - Process may take time
  - U.S. requires Form 8833 to claim a treaty position that overrules or modifies a provision of the IRC

- **Must be a resident as defined by the treaty**
  - Meet Limitation of Benefits clause
  - Prevents treaty shopping
Income Tax Treaty - Other Provisions

- Taxation of the following additional items:
  - Income from Real Property
  - Business profits
  - Gains
  - Income from employment
  - Directors’ Fees
  - Entertainers and Sportsmen
  - Pensions, Social Security, Annuities, and Child Support
  - Government Service
  - Students
  - Teachers
  - Other Income

- A separate treaty addresses Estate and Gift tax issues
Treaty Disclosures

- If taking a position on return that is supported by a treaty, many countries require disclosure of the position taken.

- US Disclosure - Form 8833
  - Required if taking a treaty-based return position where a treaty of the US overrules or modifies the Internal Revenue Code causing a reduction in tax.
  - Form is set up to provide a narrative discussion of the position taken.
Reporting Requirements
Secondment Arrangement from US to Foreign Employer

Income Tax Withholding

- Worldwide wages are reportable on US Form W-2 whether paid by American employer or foreign employer;

- Exemption from withholding for US citizens (but not green card holders) for Sec. 911 earned income exclusion and housing exclusion.
  - Form 673

- Exemption from withholding for US citizens (but not green card holders) for wages that are attributable to foreign services that are subject to mandatory foreign income tax withholding.
  - No specific employment form. Suggest “International Exempt W-4”

- US Resident Alien (RA): Can file Form W-4 with increased allowances to account for Sec. 911 exclusion and FTC’s to relieve duplicate US and foreign withholding.

- Definition of wages is the same as for US citizens/US resident aliens working within the US. Unless specifically excepted under an Internal Revenue Code section, allowances such as travel, tuition, housing, utilities, language training, etc. are generally required to be imputed into income.
Secondment Arrangement from US to Foreign Employer

- **FICA Taxation**
  - Worldwide wages paid by American employer to US citizens and US green card holders (or resident aliens under substantial presence test) are subject to US FICA taxation (no matter where in the world that the services are performed).

  - American employer would apply for US social security Certificate of Coverage to exempt the wages from foreign social insurance taxes.

  - Totalization Agreements do **not** include FUTA or SUTA.

  - US-Sourced wages paid by Foreign employer to US citizens and US green card holders (or resident aliens under substantial presence test) are subject to FICA taxation.

  - Wages paid to US citizens/US residents by foreign subsidiaries of US companies (local hires) outside of US are not subject to FICA unless an IRC sec. 3121(l) Agreement is executed via IRS Form 2032. Exception is IRC sec. 3121(z) (foreign subsidiaries engaged in US government contracts).
Secondment Arrangement from US to Foreign Employer

- **FUTA (Federal Unemployment Insurance) Taxation**
  - Worldwide wages paid by American employer to US citizens but **not** US green card holders (or US resident aliens under substantial presence test) are subject to US FUTA taxation.
  
  - Only US-sourced wages paid to US resident aliens are subject to FUTA taxation.

- Wages paid by foreign employer to US Citizens and US green card holders or US resident aliens that are attributable to US-sourced services are subject to FUTA.
Foreign Persons: US Sourced Services

- Generally, the US entity is listed on the I-129 visa petition as “the employer” who is sponsoring the foreign national to physically work in the US. As such, the wages are generally subject to US income and FICA tax withholding (unless a Totalization Agreement Certificate of Coverage is obtained by the foreign employer seconding the foreign worker to the US affiliate).

- Withholding is required at the graduated wage withholding rates rather than the flat 30% withholding rate (IRC Sec. 1441) for remuneration paid to employees.
Foreign Persons: US Sourced Services

- **Business Visitors:**
  - If treaty provisions met US-sourced wages can be exempt from income taxation under the dependent personal services article – form 8233 needs to be filed to support exemption.
  - De minimis business visitor exception under IRC Sec. 861(a)(3) requires services by foreign national for foreign employer in US for 90 days or less and paid $3,000 or less in compensation.
  - All US sourced remuneration should be reported on Form 1042-S even though a treaty exemption may apply.
  - Remuneration not exempt from US taxation under a treaty is reportable on Form W-2.
Foreign Persons: US Sourced Services

- **Business Visitors (cont.):**
  - May have to issue both a Form W-2 (FICA wages and state income taxable wages) and a Form 1042-S (treaty exempt or de minimis exemption wages).
  - Form 1040NR generally required if the NRA’s US-sourced income exceeds the personal exemption even if a treaty exemption applies.
  - Form W-4: An NRA can only claim single/one allowance.
  - There are special withholding tables and a special computational add back procedure to account for the fact that the NRA is not eligible for the standard deduction or the make work pay credits.
  - NRAs from Canada, Korea, and Mexico may claim other than Single/one.
Foreign Persons: US Sourced Services

- **FICA (Social Security and Medicare) Taxation:**
  - If the NRA (present in the US as a business visitor) is from a country with a social security Totalization Agreement, then presumably the foreign employer could apply for a social security Certificate of Coverage to exempt the US sourced wages paid by the foreign employer from US FICA taxation.
  - If no totalization Wages are subject to US FICA from day one because the foreign national is performing services on behalf of the foreign employer within the US.

- **FUTA and SUTA:**
  - Totalization Agreements do not apply to FUTA and SUTA.
    - US sourced wages generally reportable and subject to FUTA and SUTA taxation.
Questions?
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