

Expatriate Taxation and Employer Reporting – The Ties That Bind

U.S. expatriate taxation can be challenging from both a technical and an administrative standpoint, particularly when your international assignee population represents but a fraction of the human resources for whom you have responsibility! R. Scott Jones, Esq.* in the first of a series of articles on international tax and reporting matters, helps to unravel some of the ties that bind the individual's tax position with the employer's own reporting and withholding obligations in the international assignment context.

U.S. Citizen and Permanent Resident Expatriate Taxation

Not surprisingly, the vast majority of outbound assignees from the United States are either U.S. Citizens or U.S. Permanent Residents (Green Card holders). Such individuals remain subject to U.S. federal taxation notwithstanding that they reside and work outside the United States. A U.S. taxpayer may qualify, however, for what is referred to as the foreign earned income exclusion (FEIE) and an additional foreign housing exclusion or deduction under Internal Revenue Code Section 911 (Section 911).

To claim the FEIE and the foreign housing exclusion or deduction, the expatriate must:

1. Shift his or her "tax home" to a foreign country; and
2. Meet one of the two definitions of a "qualified individual" by being either:
 - a) A U.S. Citizen (or a qualifying Permanent Resident) who is a bona fide resident of a foreign country (or countries) for an uninterrupted period that includes an entire calendar tax year, or
 - b) A U.S. Citizen or (or a qualifying Permanent Resident) who is physically present in a foreign country (or countries) for at least 330 full days during any period of 12 consecutive months, and
3. Have foreign earned income.

Tax Home

For the purposes of determining an individual's qualification for Section 911, his or her "tax home" is considered to be located at his or her regular or principal (if more than one regular) place of business or, if the individual has no regular or principal place of business because of the nature of the business, then at his or her regular place of abode in "a real and substantial sense".

An individual is not considered to have a "tax home" in a foreign country for any period for which his or her "abode" is in the United States. Temporary presence of the individual in the United States, or his or her maintenance of a U.S. dwelling, do not necessarily mean, however, that the individual's abode is in the United States during the relevant period.

Qualified Individual

Section 911 applies only to a “qualified individual”. An individual is “qualified” if his or her “tax home” is in a foreign country and he or she satisfies either the Bona Fide Residence or Physical Presence Tests.

Bona Fide Residence Test

The test of Bona Fide Residence (BFR) is primarily a factual question requiring an analysis of all relevant facts and circumstances with the burden of proof resting with the taxpayer. The intent of the taxpayer, purpose of the trip and the nature and length of the stay abroad are all contributory factors in a determination of whether a foreign residence has been established and maintained.

An individual may move from one foreign country to another foreign country or make temporary visits to the United States or elsewhere without interfering with his or her status as a Bona Fide Resident of another country so long as he or she does not interrupt the qualifying period with a period of U.S. “residence”.

To qualify for BFR, however, a Permanent Resident of the United States needs to be a citizen of a country with which the United States has an Income Tax Treaty containing a Non-Discrimination Clause that affords a Permanent Resident tax treatment equal to that of a U.S. Citizen.

Physical Presence Test

Both U.S. Citizens and Permanent Residents may qualify for the FEIE and foreign housing exclusion under the Physical Presence Test (PPT). Provided an individual has shifted his or her “tax home” to outside the United States, this test is more objective than the BFR test in that it relies on a strict day count. Provided the individual spends at least 330 full days outside the United States during *any period* of 12 consecutive months, the taxpayer qualifies. In this manner, the PPT is more flexible than the BFR test in that it also covers assignments that do not encompass a full calendar year, and is often elected in years of departure from and repatriation to the United States in order to maximize the full exclusion available.

The Housing Exclusion

Pursuant to the 2005 Tax Increase Prevention and Reconciliation Act (Pub. L. No. 109-222, “TIPRA”), the FEIE that qualifying taxpayers may deduct from income on U.S. tax returns for the 2008 year is \$87,600 (\$85,700 in 2007) with additional excludible foreign housing expenses generally capped at 30% of the FEIE for the year (i.e. \$26,280 for 2008, \$25,710 in 2007). Foreign housing expenses are only excludible to the extent of sufficient additional foreign earned income available, and only in respect of the excess over the threshold of 16% of the maximum FEIE amount. This translates to a net maximum foreign housing excludible amount of \$11,998 to be reflected on 2007 federal tax returns. Both the FEIE and the foreign housing exclusion are prorated for the period in the calendar tax year that the taxpayer qualifies under the tests described above.

The reason the base housing cost of 16% of the FEIE is relevant is that for taxpayers based in high-cost locations, the 30% of FEIE limitation described can result in some anomalous results. At the taxpayer community’s prompting, the TIPRA provides the Internal Revenue Service (IRS) with the authority to adjust the housing cost maximum amount for areas with various levels of housing costs. They have done so, albeit on a somewhat piecemeal basis, by introducing city-specific dollar thresholds for excludible housing instead of the 30% limitation, but still subject to the 16% minimum threshold. Many commentators, however, agree that the IRS’ specific guidelines remain far from satisfactory both in the extent to which they encompass all deviations from the norm of 30% and also their failure to address suburban costs.

Sample Foreign Housing Exclusion Limits - 2007	\$
Default @ 30% of FEIE	25,710
London	77,800
Toronto	46,000
Paris	87,200
Frankfurt	44,600
Moscow	90,900
Shanghai	57,001
Hong Kong	114,300
Buenos Aires	43,900
Tokyo	85,700
Seoul	65,400
Singapore	56,700

The "Stacking Calculation"

The TIPRA also introduced a particular kind of tax calculation on income that remains taxed in the United States after the exclusions are applied. Commonly referred to as the "stacking calculation," this methodology was created to address a perceived inequity that taxpayers who claimed the benefit of the Section 911 exclusion paid less tax on their remaining income taxable on the federal tax return than domestic taxpayers at the same income level. This inequity was due to the impact of progressive rates of tax.

In order to correct the problem, however, the new rules seem to have the effect of creating reverse inequity by taxing remaining income at even higher rates than would have been applied at home. Now the remaining income on the U.S. return is taxed at the highest applicable tax rate on the return instead of the average tax rate on the return. This is in addition, of course, to any foreign taxes paid in the other jurisdiction. These can provide a credit against the US federal tax liability but only on income not excluded on the US tax return and then only to the extent of the average rate of US tax – not at the highest applicable rate!

Foreign Tax Credits & Interaction with Section 911

This is a natural segue to foreign tax credits and how they may be utilized. Foreign tax credits are eligible to be taken against foreign source income and may be carried back one year and carried forward ten years to the extent not used up in the current year.

As a result of the somewhat overreaching "stacking rule" that was introduced with respect to the foreign earned income exclusion, however, the election to take the FEIE and housing exclusions alongside taking credits for foreign taxes paid or accrued has become the subject of greater scrutiny. The reason for this is that, absent the election to claim the exclusions, foreign tax credits may be taken on a "standalone basis" and may be sufficient, if the foreign rate of tax is high enough, to eliminate any U.S. federal tax liability. Therefore, electing the exclusions may not yield a significantly better tax result and may now even cause the taxpayer to "waste" tax credits by eliminating those that are attributable to excluded income.

As such, although it is necessary to analyze each taxpayer's situation, there are a few key takeaways on this issue:

1. If no foreign tax is paid, it will always be beneficial to claim the Section 911 exclusion
2. If foreign tax is paid but the average foreign tax rate is lower than the U.S. rate, generally it is beneficial to claim the Section 911 exclusion
3. If foreign tax is paid and the average foreign tax rate is at least comparable to the U.S. rate, or higher, it is generally beneficial to forego the Section 911 exclusion in favor of claiming only the foreign tax credit.

There is a note of caution on this, however. The Section 911 exclusion election, once made, applies for qualifying subsequent years. Section 911 permits a revocation of the election to exclude income, but provides that, without the consent of the Secretary of State, the taxpayer may not make another election before the sixth taxable year after the taxable year for which the revocation was effective. Therefore, any immediate benefit of revoking the exclusion, in order to optimize the utilization of foreign tax credits, must be weighed against the possible downside of being unable to re-elect the exclusion for the following five years.

U.S. Citizen and Permanent Resident Expatriates – Payroll Issues

Understanding the individual employee's tax position is, of course, only one side of the equation in the international assignment context. Often of equally important, and more pressing, concern for the employer is how to manage, and properly implement, payroll reporting and tax withholding procedures for U.S. expatriates assigned abroad.

Federal Income Tax Withholding

All employers are required to withhold income taxes on wages paid to U.S. Citizens or Permanent Residents ("U.S. employees") regardless of whether the compensation for services was earned in the United States or a foreign country, or whether or not the employer is a U.S. company (see below).

An employer of U.S. employees working outside the U.S. may be relieved of its tax withholding obligations, however, where amounts paid are exempted from the definition of "wages" for income tax withholding purposes. Exceptions include wages paid to U.S. employees that are not expected to exceed the amount excludable under Section 911 and compensation for services performed in a foreign jurisdiction or "wages" that are subject to legally required (i.e. mandatory) foreign income tax withholding.

Payroll regulations require that a properly completed Form W-4 (note that foreign tax credits may be considered in determining U.S. federal withholding) and/or Form 673 (if the employee expects to qualify for the Section 911 exclusion) must be kept in the company's payroll records for such exceptions from a withholding obligation to apply. Even in circumstances where federal withholding is required, since there is no mandatory foreign withholding, Form W-4 may be used by the employee to reduce actual U.S. withholding based upon his/her anticipated foreign tax liability.

U.S. Social Security Contributions

Equally important is the assignee's and the employer's continued liability to U.S. social security contributions. FICA taxes, which include both OASDI/Medicare taxes, are payable on wages for services performed by a U.S. Citizen or Permanent Resident of the U.S. working outside the U.S. as an employee of an "American employer". As such, the social security position in respect of international assignees under U.S. domestic tax law operates as a function of the status of the employer as opposed to the employee.

An "American employer" is defined to include the United States or any instrumentality thereof, a partnership in which two-thirds or more of the partners are U.S. partners, a trust, if all trustees are U.S. residents, or a corporation

organized under the laws of the United States or of any State thereof. What is important to note in this regard is that these taxes are imposed on all wages including all allowances irrespective of where paid. For example, wages of an "American employer" paid to a U.S. Citizen or Permanent Resident through a foreign payroll are subject to FICA taxes and are required to be reported in the U.S.

Non-American employers, on the other hand, whose U.S. employees perform services outside the U.S. are not liable for FICA taxes on foreign source compensation (assuming that an irrevocable election has not been filed by a foreign affiliate entity of a U.S. corporation to remit U.S. social security taxes under what is known as an IRC Section 3121(l) Agreement). However, FICA tax liabilities and reporting requirements remain should the employees earn compensation for services performed in the U.S.

The United States also has a number of international Social Security Totalization Agreements with various countries that should be considered in this context. In many instances of assignments abroad of less than five years in duration (as is typical), the provisions of such agreements work in tandem with U.S. rules in keeping the U.S. employee in the U.S. social security system and exempting him or her from paying into the host country system, provided a Certificate of Coverage showing continuing liability at home is obtained. In this way, Social Security Totalization Agreements can often be extremely useful from a cost containment perspective in further eliminating what can on occasion be extremely expensive employee AND employer host country social security tax liabilities.

In circumstances where an employee is assigned to a "non-Totalization" country, foreign tax credit rules permit a credit to be taken for any host country social security tax that may be imposed on income that remains similarly subject to U.S. social security contributions. In this manner, at least the employee's exposure to double taxation is alleviated.

Federal Unemployment Tax (FUTA)

Employers are also subject to the Federal Unemployment Tax (FUTA) at the rate of 6.2% on the first \$7,000 of a covered employee's wages (6% in 2008 unless legislation comes into force). A credit up to 5.4% is allowed for payments made in State Unemployment Taxes.

Although the definitions of wages, employment and "American employer" for FUTA purposes are similar to those for FICA purposes, there are slight variations. For example, only services performed by a U.S. Citizen outside the United States for an "American employer" are included in employment. Therefore, services performed by Permanent Residents are not covered. Also, the United States or any U.S. instrumentality is not considered to be an "American employer" for FUTA purposes.

Foreign employers are not subject to FUTA for wages paid for services performed outside the United States.

Federal Reporting of "Wages"

Whether mandatory foreign tax withholding applies or income is excludible or not for tax withholding purposes, or indeed whether or not U.S. social security is due, the U.S. employer (and even the non-U.S. employer according to the Form W-2 instructions) is still required to provide the employee with a Form W-2 at year end showing reportable wages paid to him or her for the year. This applies both in part-years and full years of international assignment.

Bonus and Other Equity-Based Compensation Reporting

Bonus and other one-time payments in the United States or otherwise paid in respect of U.S. services are generally subject supplemental rates of federal tax withholding. The current federal rate is 25% flat withholding. The payment of a bonus subsequent to an employee's departure from the U.S. on assignment with respect to U.S. services will not qualify for credit for any foreign taxes due since it would not be considered foreign source for U.S. tax purposes. However, it is also important to establish the host country's tax treatment of such a payment while an individual is a resident of that country and which relates to U.S. services, in order to avoid potential double taxation.

From a U.S. perspective, the supplemental rate of withholding will often be less than the individual's top tax federal tax rate. At the time of payment of any bonus, it may be advisable for the employee to "reserve" for any difference in tax liability and make an estimated tax payment for such amount.

A further issue to consider is that, dependent upon the type of equity-based compensation (for example, stock options, restricted stock, or stock appreciation rights), certain jurisdictions may seek to tax such compensation vehicles differently than in the US or at different times, resulting in the potential for double taxation. Advance planning and consideration of relevant Income Tax Treaty provisions are critical to the avoidance of unnecessary tax costs.

State Tax Issues

Generally, those states that impose an income tax seek to keep those "temporarily" absent from the state taxable on worldwide income. Beyond a certain time threshold, however, many states, in accordance with their own rules, permit taxpayers to "break" tax residence and, as such, become taxable in the state only to the extent of income "sourced" to the state, such as rental income or compensation for services performed.

Important to be aware of are those states that determine continued tax residency on a "domicile" or permanent home basis. They will seek to tax income earned on foreign assignment if it is the intention of the taxpayer to return to that state upon completion of their assignment.

Moreover, certain states also do not accept the federal earned income exclusions! Therefore, each state's residency rules should be examined both from the perspective of taxability and ongoing payroll reporting and tax withholding requirements.

Payroll Delivery Location

Given the many continued U.S. compliance requirements, why not, you may ask, simply maintain U.S. payroll for delivery of compensation while the employee is on assignment? This is certainly one viable option given the continued reporting obligations imposed upon employers in respect of U.S. Citizens and Permanent Residents working outside of the country. This may also make sense for continued participation in home country benefits plans. Expatriate administrators should also be aware, however, that the host country(ies), may have separate requirements as to local income and social security tax withholding and wage reporting requirements which should be verified with host country advisors. These requirements may necessitate a "shadow payroll" reporting and re-charge mechanism to be put in place within your company's payroll operation if not already established.

Payroll Agency

You will recall from the above that foreign entities also have a W-2 reporting and tax withholding obligation in the United States for their U.S. Citizens and Permanent Resident employees even if a foreign payroll is used for actual payroll delivery and services are performed outside the United States!

This reporting obligation (unlike that in respect of social security contributions) is driven by the status of the individual as a U.S. Citizen or Permanent Resident, and applies irrespective of the status of the employer.

Typically, this scenario arises when U.S. Citizens or U.S. Permanent Residents are hired locally by the foreign entity. Clearly, a lot of foreign employers struggle with U.S. reporting for sometimes less than even a handful of affected employees. In order to be in full compliance, a practical issue arises as to how to manage such U.S. payroll tax withholding and reporting as a foreign entity. Indeed, it is questionable as to how enforceable such provisions are on non-U.S. employers.

Nevertheless, in order to be in full U.S. payroll compliance, a foreign entity may formally designate a U.S. "payroll agent". A payroll agent under the law is an arrangement whereby the employer (the foreign entity) designates another entity (often the U.S. parent company) to act as an agent with respect to issuing payroll checks, filing U.S. payroll tax returns and other reporting requirements. The employees remain in the employ of their legal employer abroad, and

the agent performs certain administrative tasks related to the employer's payroll. All provisions of law (including penalties) applicable to an employer apply in the same way to the agent. However, the employer for whom the agent performs the payroll services remains liable for the payroll obligations if the agent fails to perform them.

Once this has been achieved, the U.S. entity is then in a position to remit any necessary withholding taxes and generate year-end Forms W-2 on behalf of the foreign entity in respect of their U.S. Citizen or Permanent Resident employees.

Tax Policy Considerations

Lastly, no discussion of U.S. expatriate taxation is quite complete without at least an acknowledgement of the role of the employer's international assignment tax policy. While an in-depth look is outside the scope of this article, suffice it to say that issues extend well beyond addressing the not inconsiderable mechanical issues of compliance reporting. For the employer, understanding how to optimize and apportion an expatriate's tax position both at home and abroad between the employer and the employee is the key to successful cost containment and the management of the employee's and employer's expectations. Various policy methodologies are widely utilized in order to achieve these goals. It is recommended that steps be taken early to implement a workable policy that meets business objectives and treats international assignees equitably from a tax standpoint. These really are the ties that bind!

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