Taxline

A Quarterly Update on Developments in Personal Taxation

No. 4 2010

TAXLINE is a quarterly publication designed to discuss relevant issues in the field of international taxation. These topics are addressed in general terms, and should not be acted upon without professional advice. This edition of TAXLINE was written by Karen A. Cygal, a senior associate of Mercer (formerly ORC Worldwide) in New York.

We are pleased to announce Mercer's acquisition of ORC Worldwide.

ORC Worldwide's solid reputation and capabilities complement those of Mercer. Together we have strong global positions in mobility services, compensation data, and benefits information.

The ORC Worldwide acquisition is another demonstration of our commitment to provide you the best possible HR information services and solutions.

in this issue

fast fact

Did you know that only 6 percent of employers require expatriates to submit their tax return for a company audit?

Source: *ORC's Worldwide Survey of International Assignment Policies and Practices*

Helping Expatriates Handle International Taxes: Before, During, and After the Assignment

By Karen A. Cygal

For families going on an international assignment, the impact of the relocation on their finances may be one of the most complex and troublesome matters they encounter – particularly if the spouse stops working, either voluntarily or involuntarily due to host-country regulations. When it comes to tax, international assignments place the expatriate in a position that requires compliance with the tax regulations of two governments – the employee's home country and the assignment location.

Consequently, it is important that assignees have the opportunity to speak with an expert fully versed in the company's tax policy and international tax law before they relocate. It also helps for an employer to provide some form of practical assistance not only during the assignment but also, once the assignment is finished, upon repatriation or reassignment to another destination. The following discussion presents several key issues to be addressed – tax policy, company procedures, and employer/employee responsibilities with regards to international tax matters.

Tax Matters: General Home and Host Tax Rules

The expatriate must be in compliance with the tax laws of the home country and the assignment location. Obligations for home-country tax vary. Although most countries do not require nonresidents to report (or be taxed on) income earned outside the country, many expatriates still have continuing home-country tax obligations from non-employment income (e.g., investments).

If home-country tax liability is based on residency, and expatriates "break" residency by selling the family home or being out of the country for an extended period, they are then subject to different tax rules. (For U.S. assignees, citizens and permanent residents are subject to U.S. taxation on total income, no matter where that income is earned.)

From the host-country perspective, most governments require the expatriate to pay taxes on income attributed to working in that country, with some locations offering special tax concessions to expatriates, such as advantageous rates and deductions or credits. Overall, however, an expatriate's tax liability is likely to be higher on an international assignment for two reasons:

- *Higher Host Taxes*. Although tax rates vary from location to location, the taxes applicable to the individual, a*s an expatriate*, are higher in many countries when compared to the home-country tax system. The underlying reason is that the assignee does not have the same opportunities to reduce local tax liability as do local-national employees. Tax residents can benefit from tax-favorable treatment, as compared with nonresidents who may not be able to take advantage of the rules.

  Even though special concessions may be available for expatriates, assignees may not be able to claim the same deductions as their local counterparts for items such as mortgage interest and pension contributions because they do not own a home in the host location, or do not participate in the host pension plan. (In situations where the host-country taxes are lower than home, the result is a windfall that would revert either to the assignee or the employer, depending on how the company handles taxes.)
- *Tax-Free Allowances*. Many companies provide, on a tax-free basis, not only a number of allowances to help pay for miscellaneous expenses related to the international assignment, but also goods and services differentials to bridge the gap between home and host prices under the balance sheet approach. Although paid on a tax-free basis, these compensation elements are viewed as part of income, resulting in an increased overall income amount and tax liability.

Tax Treatment: Understanding the Basics

Of the four common tax treatment methodologies employed by companies with regards to foreign assignments, tax equalization is consistent with the balance sheet approach to international compensation. Simply put, expatriates will be no better or worse off financially than they would have been if they had not gone on assignment (with the exception of any incentive payments intended to encourage them to accept an assignment). Similarly, with regards to tax, it means that expatriates are responsible for income taxes at a level equal to what they would have incurred if they continued to live and work in their home country rather than going on assignment.

To meet the objective of keeping the employee's financial status comparable to what it had been, the company typically withholds a "hypothetical" income tax. The payroll department assesses this hypothetical amount against the expatriate's compensation at the same level as that assessed for the assignee's home-country peers. In turn, the company is responsible for tax assessed on the assignee's company-earned income (e.g., base salary, bonus), so that:

- If the expatriate's taxes are higher on assignment than what the expatriate would have paid at home, the employer reimburses the difference. Thereby, the expatriate's financial standing is not adversely affected.
- If the taxes are lower, the company — as would not happen under tax protection (described below) — retains the savings instead of the assignee.

Although tax equalization is the most common approach followed by employers, some multinational organizations prefer one of the methodologies described here:

- *Tax Protection*. While tax protection holds the employer responsible for assignees' tax liability if their income taxes are higher than what they would have paid at home, it allows the assignee to keep any windfall if taxes are lower. A major problem with this approach is that it raises a serious issue of inequity, because some expatriates in certain low-tax countries receive a windfall while those in higher-tax host locations do not.

  Another concern relates to the fact that tax protection involves an expatriate's actual tax payments, which might cause some financial uncertainty for the family. For example, the expatriate has no prior indication of the tax amount with which the company will eventually reimburse them until the following steps have been completed: filing the tax return to the proper authorities, paying appropriate tax amounts, and reconciling any differences between the amount that would have been paid had the employee remained in the home country and the amount that was actually paid as a result of the international assignment. Consequently, the expatriate family might experience a negative cash flow until the employer has a chance to reimburse what it owes the assignee.
- *Ad Hoc*. Some multinational employers have relatively few expatriates assigned to the same location, while others have expatriates situated in various host countries with no clear destination pattern. In either case, the company is usually either just launching its international assignment program as it expands operations outside the headquarters country or, by design, simply sending employees wherever needed to handle specific tasks.

  Under these circumstances, the employer often has no formal tax policy in place to address the treatment of expatriate tax, resulting in ad hoc decisions, whereby management handles each expatriate's tax situation on a case-by-case basis. Unfortunately, this methodology allows for the possibility of inequitable and inconsistent treatment of expatriate tax among the assignee population.
- *Laissez Faire*. Companies that are first entering the global market may be inclined to follow this method in the early stages of their expatriate program. This method places the entire responsibility on the assignee for calculating and paying income taxes related to both the home country and assignment location. In effect, with the employer taking a hands-off approach, assignees are left to handle their own tax filings, payments, documentation, and so forth.

It is important to be aware that a number of results are possible: (a) potential windfalls for the assignee when tax rates are lower in the host country; (b) an extra liability burden for the expatriate when tax rates are higher in the assignment location; and (c) noncompliance with government filing requirements if the assignee does not meet filing or payment deadlines, documentation requirements, and others (see sidebar, "Global Compliance and Tax-Reporting Issues").

Global Compliance and Tax-Reporting Issues

According to ORC's *Flash Survey: Global Mobility Compliance Issues* (August 2010), the most serious compliance issue noted by 61.3 percent of participants involved tax return revisions caused by improper reporting of worldwide income by expatriates. In addition, 25.4 percent reported the issue of fines and penalties imposed on expatriates due to inaccurate reporting of income, while 24.3 percent reported the issue of tax audits as a result of under-reporting of income by expatriates.

Other concerns included:

- Penalties due to late payments
- Uncertainty over correct withholding amounts
- Compliance by "stealth" expatriates and international business travelers with regards to keeping track of income
- Internal financial transactions
- Getting people to communicate ahead of time to prevent surprises
- Inability of emerging governments to track payroll remittances at the individual employee level
- Local branches not filing all information to the local tax authorities
- Compensation collection for calendar year reporting
- Application of tax equalization policies
- Non-taxation of benefits or expatriate expenses
- Share reporting
- Cost of ensuring no issues are encountered
- Expatriates providing information in a timely manner for tax preparation
- Forms needed to report late offshore wages
- Late filing due to expatriate's lack of cooperation in providing timely information for tax deadlines
- Additional tax consulting costs due to differences in timing of income reporting

Concerning payroll approaches:

- 64 percent of companies use an in-house payroll system for the majority of their expatriates.
- Less than 20 percent outsource payroll; 15.7 percent of which outsource to a local or regional payroll provider, and 3.8 percent to a global employment company.
- 54 percent typically pay expatriates entirely in home-country currency; 31.5 percent split between the home and host currencies.

To ensure that all income and payments are properly reported and tracked:

- 35 percent require each local payroll to report payments into the global mobility department on a regular basis.
- 24 percent track all payments in an internal software system.
- 10 percent enter payments into an external provider's software system.

Tax Policy: Why Bother?

Whatever tax treatment is implemented, it is important to develop a tax policy, implement that policy, and enforce it in order to ensure assignees that the company is handling their affairs in an appropriate manner. A tax policy, along with appropriate approval levels for exceptions, is also helpful in:

- Minimizing individual deals or special requests that could lead to employee morale problems if one or more assignees receive favorable treatment
- Controlling assignment costs by finding legitimate ways to reduce needless tax expenditures
- Minimizing the risk of noncompliance with home and host tax regulations by providing assignees with education, tax preparation guidance, and/or professional assistance

Maintaining a smooth cash flow for the expatriate by setting up appropriate and clear procedures and deadlines is another desirable objective. This point involves coordinating tax treatment with the payroll department. By doing so, the result should be:

- Seamless pay delivery to the assignee, whether all in home-country currency, host-country currency, or split between the two
- Problem-free year-end reconciliation between actual and hypothetical tax computations
- Accurate and timely reporting of tax items to the appropriate home and host tax authorities

Tax Responsibility: Who Does What Under Tax Equalization?

The responsibilities of the company and assignee with regards to employee tax matters under an equalization approach are clear. In general, the assignee is responsible for:

- Maintaining adequate personal records of data required for preparation and examination of income tax returns and for the income tax equalization computation
- Cooperating with the designated accounting firm to take advantage of available tax credits and exclusions
- Making any related payment of taxes in the required amounts and within the required deadlines
- Filing all required home and foreign tax returns
- Making estimated tax payments on non-company income and any interest or penalties imposed by the government tax authority relative to non-company income
- Returning promptly to the company any refunds obtained from carry-overs or carry-backs relative to company-source income (e.g., excess foreign tax credits)
- Filing an amended tax return, if necessary
- Paying the company the amount of refund if the expatriate refuses to file an amended return for assignment-related compensation or foreign tax credit/deduction items

Under tax equalization, it is the company's responsibility to:

- Provide, at company expense, tax return preparation assistance for all host-country tax returns, as well as home-country national, state, cantonal, and provincial income tax returns, during the term of the assignment (in some instances, the expatriate may remain in the tax program for the year after the assignment ends due to the timing of expatriate-related payments).
- Assist the expatriate in submitting complete and accurate returns to facilitate the tax equalization process.

- Require the expatriate to reimburse the company for a portion of the tax return preparation costs related to significant non-company business interests (e.g., farms, multiple rentals).
- Receive no information about the expatriate's tax matters without specific authorization by the expatriate.
- Determine whether to tax equalize city and local taxes.
- Determine whether to provide tax planning or advice on non-company income.
- Decide whether to make estimated tax payments, tax advances, or tax gross-ups on the expatriate's behalf to cover the tax liability on the actual tax returns.
- Reserve the sole and exclusive right to terminate, revise, or interpret income tax equalization provisions and determine the tax equalization impact of miscellaneous items or unusual circumstances.
- Ensure that all home- and host-country tax filing requirements are met.
- Decide whether to be responsible for any interest or penalties imposed by the government tax authority on company-source income (see sidebar, "Handling Penalties and Interest on Expatriate Tax Returns").

Handling Penalties and Interest on Expatriate Tax Returns

Penalties imposed by tax authorities might arise, as a result of any number of situations, such as late filing, inaccurate data, audits, and so on. Employers handle such penalties in several ways:

- Pay all penalties and interest, regardless of the situation.
- Have the expatriate pay all penalties and interest, regardless of whether or not the submission is timely.
- Require the expatriate to pay all penalties and interest only if necessary information is provided after the company deadline.
- Require the expatriate to pay related penalties and interest if necessary information is provided after the company deadline; the company pays all other penalties.
- Split the payment based on the income amount (expatriate vs. company income).
- Allocate the payment to company/expatriate based on accountability, so that the expatriate pays if the situation is caused by expatriate action or delay; otherwise, the company pays.
- Consider the situation case by case, reviewing circumstances and the culpability of the assignee.
- Have the expatriate pay at least a portion of the amount if information has been submitted in an untimely manner.
- Base the decision on the reason for the penalty or interest, with guidance from an external consultant.

Tax Preparation: Education, Expertise and Beyond

Before the expatriate begins the assignment, either an international HR administrator or tax practitioner (in-house or external expert) should ensure that some key data is available. This information, provided in a timely manner, relates to items such as:

- Contact information for the tax specialist(s) who will assist the expatriate prior to the move, during the assignment, and upon repatriation or reassignment
- A clear understanding (and copy) of the company's tax policy with regard to international assignments
- Details on the specific items of income that are taxable versus those that are provided on a tax-free basis
- Tax filing deadlines
- The party responsible for tax filing, payment of taxes, and so on
- An explanation of the year-end tax reconciliation process and procedures for handling the expatriate's liability, if any
- A clear understanding of both relevant home-country and assignment-location tax laws that come into play as a result of the international assignment – residency issues, home-country tax provisions, host-country tax concessions for expatriates, and so on

While it is ideal for companies to offer comprehensive services to expatriates in the area of tax planning and preparation, it is not always practical to do so. Cost pressures sometimes limit the amount of services that a company will offer. For others, it is a matter of policy, with certain items designated for specific management levels.

Does the assistance continue after the expatriate returns home (or is reassigned)? While some employers provide some type of guidance as needed, others stop doing so one year after repatriation or immediately at the conclusion of an assignment.

Going beyond the basics of tax advice, some employers offer additional services to certain levels of expatriate – either to all assignees or certain managerial levels. Supplementary services typically include planning for one's estate, preparing a will, establishing a power of attorney, reviewing life insurance policies, planning for general tax or financial portfolios, and others.

The Bottom Line: Knowledge Benefits All Parties

As with cultural and language training, moving logistics, and the emotional impact of relocating to a foreign country, careful preparation and knowledge in the tax arena will help make the transition smoother for the expatriate family. By providing them with access to tax experts, whether internal staff or external vendors, HR management reassures assignees that they will get answers to complicated questions about residency rules, tax liability, document filing, and others. With the family facing less anxiety about the assignment, the company's overall administrative effort gets easier, too.

ABOUT MERCER