Frequently Asked Questions:

How Are Taxes Handled During an Expatriate Assignment?

International assignments are complicated by tax regulations both at home and abroad. Home-country and foreign tax laws, as well as company policy, determine how an employer will treat your spouse's or partner's income, your income from investments and other sources not related to the company, as well as property ownership. In general, however, the majority of multinationals attempt to focus their expatriate compensation programs, including the treatment of income tax, around the following principles:

- You will neither gain a windfall nor suffer undue financial burden as a result of the special circumstances and complexity of compensation and tax matters while you are on an international assignment.
- You and your employer must comply fully with the tax laws and filing requirements of both home and host governments.
- Your employer's policies are fair and reasonable, equitable to all employees, cost-effective, easy to administer and easy to understand.

The following questions address the most common issues regarding the treatment of income tax during the international assignment.

How Do Home- and Host-Country Tax Rules Generally Differ?

From the host-country perspective, most governments require that you, as an expatriate, pay taxes on income attributed to working in that country. Obligations for home-country tax vary. Although most countries do not require nonresidents to report (or be taxed on) income that you earn outside the country, many expatriates still have continuing home-country tax obligations from nonemployment income, such as investments.

Why Is an Expatriate's Tax Liability Often Higher?

It is likely that your tax liability will be higher when you go on an international assignment for two reasons:

- *Host Taxes*. In many countries, the taxes applicable to you, as an expatriate, are higher when compared to your home-country tax system because you do not have the same opportunities to reduce your local tax liability as do local-national employees. While you may find special concessions available for expatriates, such as advantageous tax rates and deductions or credits, individual circumstances do not always allow assignees to claim the same deductions as their local counterparts. For example, you will probably rent a home while abroad, thus preventing you from taking any existing tax deduction for mortgage interest. Another possible reason is that you are likely to make charitable and pension contributions in your home country, again prohibiting the use of deductions. On the other hand, there will often be situations where the host-country taxes are lower. These cases result in a windfall that would revert either to you or your employer, depending on how the company handles your taxes.
- *Allowances*. Many companies provide allowances on a tax-free basis to help you pay for miscellaneous expenses related to your international assignment. For example, your employer might provide a relocation allowance to cover unspecified settling-in expenditures, such as new drapes or locks for the family residence. Or, the company might pay a car allowance to supplement loan payments or a hardship premium to compensate you for living and working in a dangerous or difficult location. Even goods and services differentials to bridge the gap between home and host prices are generally provided tax-free. However, as they are considered part of your income, it will raise your overall income level, resulting in a higher tax liability.

How Do Employers Treat Expatriate Tax?

Employer practice ranges from heavy involvement (making complex calculations) to little or none (making the employee responsible). Although there are four common methods of treating expatriate tax – equalization, protection, ad hoc treatment and laissez faire – the latter two are rarely used:

- *Laissez Faire*. Companies first entering the global market are sometimes inclined to

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use laissez faire 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 your home country and assignment location. In effect, you are on your own when it comes to tax matters. A number of results are possible: potential windfalls when taxes are lower in the host country, an extra liability burden when taxes are higher and noncompliance with government filing requirements.

- *Ad Hoc*. When a company has relatively few expatriates in the same location (or no clear destination pattern), either because it is just beginning its international assignment program or by design, it often has no formal tax policy. Management handles each expatriate's tax situation on a case-by-case basis, allowing the possibility for inequitable and inconsistent treatment of expatriate tax.
- *Tax Protection*. This method holds your employer responsible for your tax liability if your income taxes are higher than what you would have paid at home. However, it allows you to keep any windfall when taxes are lower. A major problem is that windfalls available only to some expatriates raise a serious issue of inequity with your colleagues in other locations. Other points of concern relate to the fact that tax protection focuses on your actual tax payments. Consequently, two adverse results might cause some uncertainty: (1) You have no way of knowing what to expect regarding your tax reimbursement until you have filed the tax return, paid your taxes to the proper authorities and reconciled any differences between what you would have paid had you stayed at home and what you had to pay as a result of the international assignment; and (2) as a result, you might suffer a negative cash flow until the company has a chance to reimburse what it owes you.
- *Tax Equalization*. This method is consistent with the balance sheet approach to international compensation: As an expatriate, you will be no better or worse off financially than if you had stayed at home. In other words, you will be responsible for income taxes at a level equal to that incurred if you had continued to live and work in your home country rather than going abroad. To meet the objective of keeping you "whole," your employer withholds a hypothetical income tax that is assessed against your compensation at the same level as that assessed for your home-country peers. In turn, your employer is responsible for the tax assessed on your company-earned income (e.g., base salary, bonus). If your taxes are higher on assignment than what you would have paid at home, your employer reimburses the difference; if they are lower, the company keeps the savings.

Is All Income Included in Tax Equalization?

The answer varies by company policy as to what income elements will be tax-equalized. Complicating the issue is the fact that authorities in your home and host countries may (or may not) assess taxes on both your company-source income as well as any outside income from investments and your spouse or partner's employment. Although many employers limit their coverage to income directly related to your job, some include a portion of outside income. When they do, their equalization of outside outcome is generally similar to that of company-source income.

Why Does Your Employer Deduct a Hypothetical Tax?

Under tax equalization, the hypothetical tax (which is subtracted from base salary and retained by your employer) approximates the amount that would be paid by your home-country peers at a comparable salary level and family size. For practical purposes, making a hypothetical deduction is easier than calculating your actual tax liability, which would require details of your financial circumstances. Such calculations would be problematic for one expatriate; imagine that same task multiplied by hundreds of assignees, each with a different home-host combination and tax-related situation.

In general, your employer will use the hypothetical tax it has withheld from your paycheck to submit payments for your home- and host-country taxes. Should the foreign authorities prohibit your employer from paying your foreign taxes directly, you would be responsible for payment (with subsequent reimbursement by your employer). You may also be responsible for home-country tax payments on non-company-source income (such as investments).