

Hypothetical Taxes: What the Calculations Mean

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The provisions of an expatriate policy must not only consider the potential tax implications of an international assignment, but also define how income tax will be treated by the employer. While expatriates are generally subject to the tax laws of both their home country and assignment location, most countries (with the notable exception of the United States) do not require nonresidents to pay tax on employment-related income.

With consideration of existing tax regulations, many multinational organizations intend their tax policies to accomplish three primary objectives:

- Equitable treatment for all expatriates regardless of the country to which they are relocated;
- Assessment of a tax burden that is comparable to that of the assignee's counterpart back home who has the same salary and family size; and
- Compliance with the tax laws, reporting requirements, and payment procedures of both the home country and assignment location.

Tax equalization, consistent with the balance sheet approach to expatriate compensation, is the methodology through which most employers meet these objectives. Three quarters (76.1 percent) of the participants to the *Mercer 2010 Worldwide Survey of International Assignment Policies and Practices* tax equalize. This approach avoids both a tax burden on the individual transferred from a low-tax to a high-tax country, as well as any windfalls for those employees who move from a high-tax to a low-tax assignment location. Thus, expatriates neither gain nor lose purchasing power as a result of any given tax situation.

Expatriates are expected to pay only that amount to home-country tax authorities that they would have had to pay were they never to leave home. That is, the typical expatriate's home-country tax bill should be comparable to the tax liability of the employee who stayed behind. How employers estimate this tax liability is the focus of the following discussion.

Why Use Hypothetical Taxes?

Under tax equalization, the employer deducts from base salary a hypothetical home-country tax. This action is easier than attempting calculation of the actual tax liability, which would demand detailed consideration of every assignee's financial circumstances.

Government authorities generally require that an employee's paycheck represent gross salary minus applicable taxes (and other deductions are possible, such as medical premiums). The amount withheld from a paycheck, however, is not precisely the amount the employee pays in taxes—and the same holds true for hypothetical taxes.

Under tax equalization, the employer usually pays the expatriate's home-country taxes (based on the hypothetical tax computation) and foreign tax obligations (based on actual liability) through reimbursement to assignees, if they had already paid the taxes. (It is rare for employers to pay foreign tax liability directly to the tax authorities.) To make appropriate payments, the employer must have hypothetical tax data on hand. Once the most up-to-date information is obtained from the appropriate resources, hypothetical taxes are computed for the specific home country.

First, the Assumptions

When calculating hypothetical taxes for specific home-country locations, two assumptions are necessary for consistency:

- All income is employment-based salary income. Under this assumption, any income from capital or investments should not be the employer's concern in international assignments, nor should state and local tax refunds, alimony received, and similar items (see Chart 1, Defining Income for Hypothetical Tax Calculations, for items that employers might include as income). Although government authorities may assess taxes on outside income that is not company-source income, such income is excluded to keep the hypothetical tax calculations from becoming too complicated and unwieldy. Many organizations, however, do include non-company-earned income in their final year-end calculations.
- Only one person in the family is employed. This assumption is justifiable based on the difficulties of an expatriate's spouse finding a job in the assignment location. In many countries, the spouse or partner is not allowed to work and, therefore, brings in no additional income.

Depending on the specific location, other assumptions might be included for items such as mortgage interest, charitable contributions, and/or pension contributions.

Chart 1 Defining Income for Hypothetical Tax Calculations

Are the following items subject to a hypothetical income tax?

Pay Component	Percentage of Respondents Who Answered "Yes"
Base salary	97.0
Sales commission	94.0
Bonus	91.5
Incentive compensation	91.0
Foreign service/mobility premium	73.2
Goods & services allowance/COLA	72.8
Employer-issued stock options	72.6
Other allowances	69.5
Housing allowance	69.1
Hardship allowance	68.3
Company car	68.2
Relocation allowance	65.0
Club membership	61.5
Home leave	58.1

Source: Mercer 2010 Worldwide Survey of International Assignment Policies and Practices

Next, the Calculations

With these assumptions in place, calculations for a hypothetical home-country tax follow this general pattern:

- Determine income (salary only) and family size.
- Subtract from income any allowable deductions. For example, deductions in the United States are available to taxpayers in two forms: standard (a number published and updated every year by the government) and variable (additional items that the tax authorities consider legitimate deductions from income, such as local taxes, mortgage interest paid for a home, charitable contributions, property taxes, real estate deductions, rental income received, alimony paid, losses from sales or exchanges, and certain medical and dental expenses). Taxpayers choose to take the larger deduction, which will result in a lower tax payment.
- Subtract from income any allowable exemptions. For example, in the United States, such amounts are often available for each family member and are subtracted from taxable income as a personal deduction.
- Determine the appropriate gross tax rate from net income.
- Add applicable surcharges or excise taxes.
- Subtract any applicable credits, which reflect the amounts deducted from potential taxes in relation to specific items (e.g., the number of children in a family). The remaining number represents the hypothetical tax.

Chart 2 Calculating a Hypothetical Tax for the US

Assumptions: personal exemption for each individual is USD3,700; standard deduction for a couple is USD11,600; tax credit of USD1,000 for each child. The 2011 U.S. federal marginal tax rates and brackets for a married couple are:

If Taxable Income Is (USD):	The Tax Is:
0 - 17,000	10% of taxable income
17,001 - 69,000	USD1,700 + 15% of excess over USD17,000
69,001 - 139,350	USD9,500 + 25% of excess over USD69,000
139,351 - 212,300	USD27,087.50 + 28% of excess over USD139,350
212,301 - 379,150	USD47,513.50 + 33% of excess over USD212,300
379,151 +	USD102,574 + 35% of excess over \$379,150

Tax for a family of three (married couple with one child) at an income of USD100,000 is determined as follows:

Income	USD100,000
- Personal Exemptions (3)	- 11,100
- Standard Deduction	- 11,600
Taxable Income	USD77,300

Tax

On \$17,000 (at 10%)	USD 1,700
On \$69,000 minus 17,001 (at 15%)	7,800
On \$77,300 minus 69,001 (at 25%)	<u>1,075</u>
Total	10,575
- Credit	- 1,000
Total Due	USD9,575

Taking Hypothetical Tax a Step Further

Using the United States as a home country, most of the information needed to calculate the hypothetical tax is available through the IRS on an annual basis. Beyond the basic scenario shown in Chart 2, two other factors affect this calculation: the U.S. federal itemized deduction and average state and local taxes. State and local taxes represent the nonfederal income taxes due to state governments (for all states excluding Florida, New Hampshire, Texas, and a few others) and local governments (e.g., New York City). Most states have exemptions similar to the federal government.

Consult the Experts

In dealing with expatriates, HR administrators must understand not only the rationale behind the organization's tax policy, but also how it works. Mercer provides data for hypothetical tax calculations, which the employer uses to estimate the expatriate's home-country tax liability. It is important for employers to reconcile this liability with a mock home-country tax return at the end of the tax year to resolve any discrepancies.

By avoiding windfalls and shortfalls through tax equalization—and paying the employee's foreign tax liability—the employer prevents the expatriate's changing tax situation from affecting his or her purchasing power during the international assignment.

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