Top 10 mobility issues for Tax Directors to think about

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Tax Directors—

The top 10 global mobility issues that need to be on your radar

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Global Mobility

'Top Ten' issues for Tax Directors to think about

Cross border employee mobility is exploding. Companies are struggling to keep up with the demand for mobility and the compliance issues associated with it. Human Resource (HR) departments are implementing global mobility programs designed to manage complex international relocations and get talented employees on-site where needed, often at a moment's notice. However, the activities of individuals in foreign locations can create a variety of both individual and corporate level tax issues for the enterprise, depending upon the circumstances. These issues are many times intertwined with each other and can become unexpectedly complex to address.

Focus on compliance risks, upfront planning, and budgeting

The #1 job of the global mobility tax program is to effectively deploy human talent to the location the service provider is needed in a cost effective and efficient way. However, the corporate tax department's responsibility is typically broader: Managing corporate level tax liabilities and engaging in upfront planning involving all international business in order to reduce the organization's overall effective tax rate. And, top management typically taps the corporate tax department to manage compliance risk for all domestic and foreign tax liabilities, i.e., they are ultimately responsible for any tax-related problems that arise.

As part of managing compliance risks, the corporate tax department should also understand areas that can require more in-depth, complex analysis and may potentially increase risk. Although the corporate tax department may not be responsible for performing the actual individual assignee tax calculations, there are several issues that arise that are particularly challenging.

The 'Top Ten'

Listed below are the top 10 global mobility issues that corporate tax departments should consider. This list is not exhaustive. Rather, it is designed to provide corporate tax teams with a high-level understanding of issues impacting mobility programs to help them identify relevant corporate tax issues and franchise risk.

Critical issues facing the globally mobile workforce

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1. Cross border employment structures

Corporate tax departments should be involved when deciding the proper structure of temporary international work assignments. Many companies adopt a so-called home country model that attempts to maintain a 'common law' employment relationship with the home country employer and loan or 'second' the employee to the foreign affiliate. This allows the employee to continue their employment relationship with the home country employer for continuity and consistency of benefits while providing a link to the host country employer for execution of assignment related activity (wage withholding and reporting, assignment related benefits, etc.) Other companies may opt for a home/host agreement with salary being delivered by more than one entity making the determination of the ultimate employer a critical factor.

How do different employment structures affect the enterprise and reduce risk? How do companies facilitate the cross-charge of costs and substantiate corporate deductions? Employment relationships should be clearly documented to substantiate the employer relationship, the entity benefiting from the services and the process by which intercompany charges should be facilitated.

Typically, an assignment letter is issued to the employee that documents the duration of the short-term move and explains the international benefits being offered. But they do not always expand upon the individual's relationship with the host country entity or even state who is the employer. Proper intercompany documentation of the facts could help to eliminate any misunderstandings that might otherwise exist with respect to whether the employee's activities create corporate tax exposure. Upfront analysis should allow the corporate tax department to weigh in on more complex assignment scenarios.

Contemporaneous documentation also enables the entity to be better prepared in case of an audit. This documentation often serves as a beginning roadmap for auditors that are seeking substantiation for deductions and proof of compliance with transfer pricing requirements.

Actions to think about: *Companies need to choose and document efficient cross-border employment structures that enable tax, business, and other compliance needs. The process starts with asking a variety of questions that should drive the necessary documentation. Which entity should be treated as the employer of the assignees and for what purpose? What is the expected compensation and benefits cost allocation between related entities during the assignment period? What entity will ultimately bear the labor costs and claim the tax deduction?*

The documentation should make clear what the inter-company service relationship is between the home and host country entities as well as the relevant employment relationships. Whatever intercompany agreement is put in place, it is not a substitute for the international assignment letter issued directly to the employee. The two should be in harmony and not contain any conflicting statements.

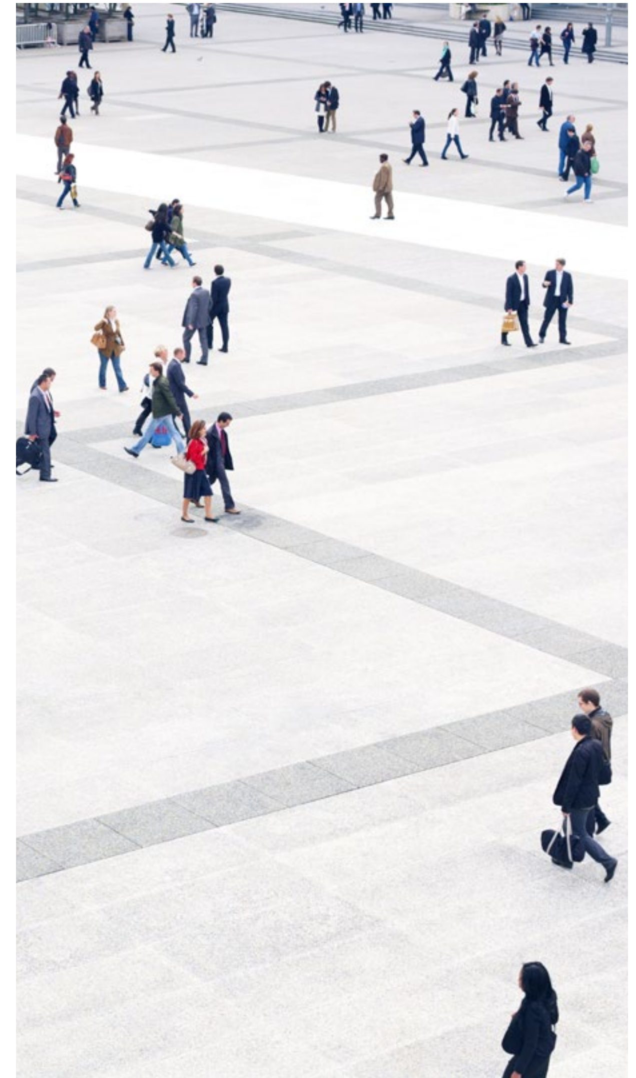
2. Enterprise level tax risks

The international relocation of 'employees' on short and long-term assignments (typically anywhere from 3 months to 5 years) may create so-called permanent establishment (PE) risk for the enterprise. Companies may fail to establish or enforce guidelines designed to limit the creation of a taxable presence for the home country 'employer'. The actual presence of the individual in a foreign jurisdiction may create an unintended taxable presence. The unfortunate result can be the requirement to register as a taxpayer, file local country returns, and remit taxes. The failure to do so could result in interest, penalties, and other costs and sanctions.

A variety of enterprise level tax obligations may be generated, in addition to the individual's liability. These include income tax liability for the employing entity, as well as an obligation to charge or otherwise account for value-added type taxes (VAT). This latter tax may arise because the performance of services in many countries by globally mobile individuals may generate VAT obligations.

Actions to think about: *Corporate tax departments need to understand the structure and nature of temporary international work assignments. How many employees will be working in a particular location? What activities will they be doing? What is the duration of time in-country as well as the long-term plan for operations there? All of these factors are necessary to gauge the level of enterprise tax risk by jurisdiction.*

Working with HR departments and monitoring this risk for global mobility programs should be a fundamental part of the corporate tax department's risk management activities. Further, the tax department may think about when this coordination with the HR function should occur—after the globally mobile individual is overseas, or perhaps before the activity takes place in the planning stage? How to efficiently manage these enterprise level tax risks can vary greatly depending on the organization.



3. Frequent business travelers

Many companies employ individuals who are resident in one country, but who travel (sometimes quite frequently) to other jurisdictions to conduct business activities. Business teams may incorrectly assume that if an individual spends less than a specified number of days in a particular tax jurisdiction (usually 183), there are no tax consequences resulting from the individual's activities. This is often not the case since the frequent business traveler may not be resident in a treaty partner country that contains favorable thresholds for incurring tax. Or, depending on the structure of the assignment, an individual may not be eligible to use the treaty.

What adverse consequences may arise? In addition to incurring individual income taxes, the nature of the individual's activities may create corporate income and value-added tax exposures in the host country. This may occur even if the time spent there is relatively limited. In addition, there may be immigration issues to contend with if an individual is travelling frequently to a foreign location. These concerns apply equally to inbound and outbound internationally mobile executives.

Tax directors are becoming increasingly concerned about the potentially adverse tax consequences caused by these travelers. Countries are expanding their audit activities due to their need for revenue to fund fiscal deficits. Audits related to PE, employer withholding and reporting are becoming more frequent and aggressive. Tax authorities may inquire about company personnel and their in-country presence. However, the company's task of compiling such information in response may be very challenging if no process is in place to track this information.

Actions to think about: *Companies should review the activities of employees who travel across borders on business to determine whether there is any tax exposure at either the individual or corporate level. A treaty may provide relief from personal income tax for short term business travel under the dependent personal services article. However, to claim such relief, most treaties tie personal income tax liability to whether the corporate employing entity has a PE in the host jurisdiction, a conclusion only the corporate tax department is likely going to know.*

In addition, one must consider whether employment costs are recharged to an affiliate in the country where the individual is working. The treaty may also look at the length of time that services are provided to determine if corporate income tax is due. For example, is the business travel part of a larger group of employees working there and perhaps part of a plan for a long-term presence in that country?

A significant challenge is that the company may or may not be aware that frequent business travelers are present (hence the term 'stealth travelers'). Companies may consider establishing a monitoring program by leveraging technology so as to document and understand travel patterns and exposures.

4. Intercompany equity charge-back agreements

In many situations, stock-based compensation granted by a parent corporation may not be deductible at the foreign affiliate level for corporate tax purposes unless active steps are taken to recharge the cost of the stock award to the foreign affiliate in exchange for a cash payment from the affiliate to the parent. This is the case generally—even where the foreign-based employee has been subject to personal income taxation on the full fair market value of the stock award, usually at vesting/transfer.

Note that US GAAP and international accounting standards generally require the stock-based awards to be recognized as an expense on the books of the corporation over the vesting period. The ability to claim a cash corporate tax benefit for the compensation amount to be realized by the employee at vesting/transfer can be an important consideration in minimizing costs to the enterprise. On a related point, depending on the method used to account for such awards in the United States, it may be necessary to determine whether the method of settling stock awards creates unintended liability accounting owing to the minimum statutory withholding requirements.

Actions to think about: *As a general rule, equity recharge agreements should be established to ensure that the foreign affiliate that is benefiting from the services of the foreign based employee bears the cost of the stock-based compensation. The agreement should be clear on the allocation method of the cost connected to the stock-based award where the employee provides services to more than one affiliate during the stock vesting period.*

In addition, stock awards may be 'net settled' where shares are provided to the employee net of withholding tax and the employer is using its own funds to cover the withholding taxes payable to government agencies. The company should review whether the foreign withholding rate(s) used is higher than the applicable statutory minimum as this can sometimes lead to adverse accounting implications.

5. Deferred compensation arrangements

In many situations, US-based deferred compensation arrangements are not necessarily tax deferred under the laws of foreign jurisdictions. Companies may not be aware of the technical difficulties in achieving a deferral under foreign law and thus, compensation may become taxable at vesting to employees. This may occur despite the fact that no cash payment has been made to the employee to fund the tax. The result: Unforeseen tax costs that could be passed on to the employer under the terms of a tax equalization or protection agreement.

From a US tax perspective, Section 457A creates special issues for companies where vesting of deferred compensation rights occurs but payment is deferred in certain countries that do not have a tax treaty with the United States and/or where the enterprise itself is subject to limited taxation. Similarly, overseas deferred compensation arrangements will need to be reviewed to ensure compliance with Section 409A where foreign executives are sent to work in the United States (even if the individual maintains non-resident alien status) or where US citizen employees are locally employed by a foreign entity.

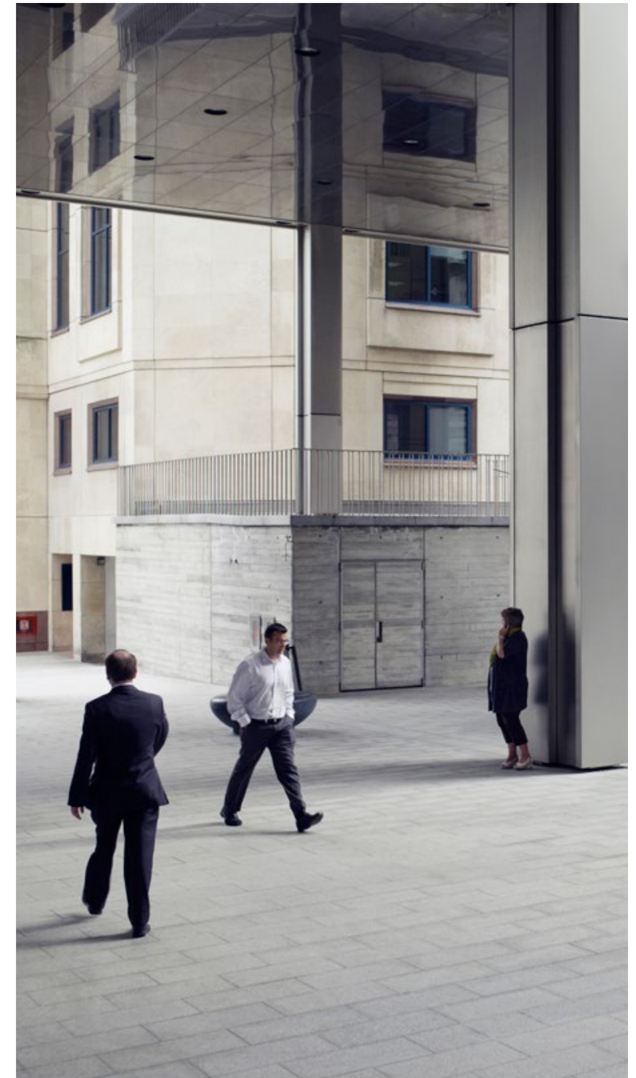
Actions to think about: *Deferred compensation plans should be reviewed for effectiveness in non-US jurisdictions and non-US plans should be reviewed for US compliance where participants may be (or may become) US taxpayers. These plans have created the need for companies to manage compliance in multiple locations for a single employee who has relocated and earned (or deemed to earn) compensation in several countries. Companies may consider modifying such arrangements or discontinuing their use for certain employees.*

The application of Sections 409A and 457A should also be reviewed to determine if modifications can be achieved to avoid accelerated US taxation and/or penalties. Note that any company with a contractual vesting clause in their deferred compensation plan may need to focus on Section 457A for US employees working for the benefit of a foreign affiliate in a non-treaty country. An example of a contractual vesting clause may be where the retirement eligible employee's age plus their years of service may result in immediate vesting at grant of an award.

6. *Foreign pension plans*

Many multinationals employ foreign nationals in the United States who remain covered by a corporate retirement program in their home country. In some cases, where the plan is both funded and vested, there is a potential US tax liability (and reporting requirement on the employer) under Section 402(b). If the individual is a highly compensated employee, it may be necessary to capture taxable income from the 'accrued vested benefit' (which includes the growth in value), even where there are no current employer contributions. A number of treaties provide for favorable tax treatment of employee contributions, employer contributions and growth in foreign plans, as well as providing for corporate tax deductions where otherwise not available. Rules can differ widely so individual treaty analysis is required.

Actions to think about: *Foreign pension plan participants who are US taxpayers should be identified to determine whether and to what extent they may have US taxable income resulting from plan participation. This can arise when the plan is funded (Section 402(b)) or unfunded (Section 409A). Form W-2 reporting requirements should also be reviewed. Where individuals are in plans potentially covered by a treaty, the terms of the treaty should be reviewed to determine whether and to what extent relief is available.*



7. Withholding and payroll compliance

Payroll compliance has become a key area of audit for many countries, particularly where the country obtains a significant share of revenue from payroll withholding and social security type taxes. In addition to withholding income and other taxes, companies may have requirements to remit their separate share of social security and other payroll taxes. Proper reporting to the individual and tax authority must also occur. The potential result of noncompliance may include unexpected tax and other costs, interest, penalties, and a drain on resources if an audit occurs.

A potentially costly example relates to the US state and local income tax withholding requirements. Many states have rules that define state residency during temporary work assignments, allowing an employee to 'break residency' with that state if certain requirements are satisfied. For this reason, many employers often stop US state and local withholding at the time a US individual commences work outside the United States. However, US state and local income tax may still be due because the individual fails to meet the requirements to break residency, i.e., an unanticipated residency status or State workdays during the assignment period.

Depending upon the state, the requirements to break residency can be complex to track and difficult to satisfy. Consider the following example:

In New York State (NYS), domiciled individuals remain subject to NYS taxation on worldwide income unless they can meet the so-called '450 / 548 day test'. This test requires the domiciled individual to be physically present in a foreign country for 450 out of 548 consecutive days and for the employee, spouse, and dependent children to have 90 or fewer days of physical presence in NYS during such period. There is also a special 'short period' test that needs to be met which limits the number of days of NYS presence during a part-year period. Recent NYS guidance also provides special rules for divorced taxpayers with dependent children living in NYS under a divorce or separation agreement.

Actions to think about: *Employers should evaluate whether they are properly fulfilling their global payroll obligations, which can include withholding, social tax obligations, as well as reporting requirements. Lack of compliance with these obligations can result in penalties and interest for the company that, for example, should have withheld tax amounts—costs the corporate tax department wants to avoid. And, they should seek an understanding of the common pitfalls in the jurisdictions in which they have more significant operations.*

Specifically regarding the US, companies should review the US state and local tax withholding obligations for their US-based international assignees. Their careful review of these US tax rules should also enable them to properly advise employees of their exposure to state and local taxation. If the employee claims to be a non-resident, certain documentation may need to be filed. In NYS, for example, Form IT 2104.1 must be obtained from each individual who is claiming to be a non-resident.

8. Information reporting requirements

New Section 6038D has created complex information reporting requirements for certain US citizens or resident employees that hold Specified Foreign Financial Assets (SFFAs). This new provision mandates reporting on IRS Form 8938 for a broad array of foreign assets, not just foreign bank accounts, and can levy expensive penalties for noncompliance. For example, if a US citizen or resident holds an interest in a foreign pension plan, that interest may be reportable. In addition, certain deferred compensation arrangements offered by non-US parent companies may be reportable under these new rules and valuation of these plans can be complex.

Foreign bank account reporting (so-called FBAR) on Form T.D. 90.22.1 also remains a challenging process that must be managed for US resident tax filers. This filing requires reporting if a US person has certain financial interests or signatory or other authority over certain foreign accounts. The FBAR is in addition to the reporting under Section 6038D and is filed separately (as opposed to Form 8938, which is attached to the individual's annual US federal income tax return.) From a practical perspective, much of the same information may need to be reported on both forms; nonetheless, there are key differences requiring attention to detail.

Actions to think about: *Companies should understand the process for completing IRS Form 8938 as required by Section 6038D and raise questions regarding compliance in this area. Consideration should also be given to the filing of FBARs especially in light of the new reporting rules for employees who have signature authority but no financial interest in certain foreign accounts owned by the employer. These reporting requirements may arise particularly for corporate executives or other high-net worth employees who are on an overseas assignment.*

9. NRA director fees

It has become more common in recent years for companies to have directors on their boards who are resident in other countries (so-called NRAs or non-resident aliens). For US companies with NRA directors, this can present a number of unique withholding and reporting issues. An example is the determination of the US source portion of any director's compensation where the individual is a non-resident alien and duties are performed both in the United States and overseas. Similarly, many US citizens are now on the boards of foreign companies and the terms of certain treaties can result in fees for any meetings held in the US being treated as sourced to the country where the company is resident. There may also be social security issues to consider for US directors of foreign companies which in some cases can be mitigated under a social security (totalization) agreement.

In addition, an unexpected and potentially adverse tax result may occur where a non-US company conducts its director meetings outside the jurisdiction of the entity. In many countries, this may give rise to the entity having a tax residence elsewhere if that residency depends on the entity's place of management and not solely its place of incorporation. This may potentially cause other tax filings and liabilities.

Actions to think about: *Companies should review the status of directors on the boards of companies not resident in the countries where the directors reside. They may develop a process of tracking director meetings to determine any portion of directors' fees earned in another country. In addition, treaties should be reviewed to determine whether any exemption or modification of taxable income is applicable and ensure completion of appropriate documentation (e.g., IRS Form W-8 BEN) to validate the foreign status of directors.*

10. Tax equalization costs

Most companies utilize so-called tax equalization arrangements. These arrangements are economically equivalent to a tax swap—the entity itself becomes obligated to pay the actual US and foreign tax amount imposed on the employee in consideration for the employee paying a 'hypothetical tax' amount. Because of the complexities in the compensation and benefits offered to the employees—and the variable payments to be made either in the form of non-guaranteed bonus awards or stock-based payments—many companies struggle to properly budget and account for tax equalization expense.

Actions to think about: *Companies should develop a base line cost estimate of their tax equalization expense and formalize an accounting policy to deal with the variable pay components. Steps should be taken to avoid large tax equalization and gross-up payments that are not properly budgeted and accounted for within the books and records of the entity. Examples of such steps may include the following:*

- *Companies may consider limitations on reimbursement of employee tax amounts in the case of non-company income or distributions from related partnerships where such amounts may create significant exposure to the entity. For example, certain partnership distributions that are treated as capital gains under US law may be treated as ordinary income under foreign laws. The tax rate differential may be passed on to the company under a traditional tax equalization agreement unless changes are made.*
- *Companies may also consider policy changes for employees who are separated from employment but who remain resident in a foreign location. Should these employees be able to expose the entity to increased tax gross-up costs on final tax equalization settlements?*
- *Companies should also review their tax equalization policy documents to include language regarding any delayed tax reimbursements pursuant to Section 409A.*

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