The Fundamentals of Global Payroll
2016 Midwest Regional Payroll Conference—Kansas City, Missouri

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Deloitte Tax LLP
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Agenda
Fundamentals of Global Payroll

Module 1: Expatriates from the US
- Lesson 1: Tax Exclusions
- Lesson 2: State Considerations for US Expatriates

Module 2: Basic Types of Assignments

Module 3: Tax Equalization and Hypothetical Taxes
- Lesson 1: What is Tax Equalization?
- Lesson 2: Hypothetical Income Tax Deduction

Module 4: Mirror (Shadow) payrolls
- Lesson 1: Mirror or Shadow Payrolls

Module 5: Foreign Compensation Collection
- Lesson 1: Foreign Compensation Collection–How does it impact payroll?

Module 6: Expatriates to the US
- Lesson 1: A Framework for Inpatriates (Time permitting)
Course Objectives:
Fundamentals of Global Payroll

Upon completing this course, you should be able to:
• Describe qualifying tax exclusions for expatriates
• Describe basic types of expatriate assignments
• Define the objective of tax equalization and the hypothetical income tax deduction
• Explain the concepts & purposes around mirror (shadow) payrolls
• Describe how foreign compensation collection impacts payroll
• Identify the basic criteria for resident and non resident aliens
"Excellence is Mastering the Fundamentals"
Expatriates from the US (US Outbounds)
# US Expatriates: Qualifying for Exclusions

## Starting Point
- US citizens and Lawful Permanent Residents (Green Card Holders), are required to report on their US tax return, their worldwide income regardless of where the income is paid or earned.

## Bona Fide Residence Test
- Employee on Non US Assignment must prove that he/she is a bona fide resident of the foreign location for an uninterrupted period which also includes a full calendar year:
  - Family joins with intention of making the location their home for the duration of the assignment
  - Purchase of a home or a long term lease agreement in the foreign location
  - Terms of the “Offer letter”, “Assignment Letter” or contract
  - Type of visa to enter the foreign country

## Physical Presence Test
- Employee must be present in the foreign country for at least 330 days during any consecutive 12 month period (or a 365 day period):
  - The period may begin with any day of any calendar month (i.e. whatever days provide the greatest income exclusion) and ends the day before the same day, 12 months later. Days need not be consecutive.
IRS provisions to eliminate double taxation

- **Foreign Earned Income Exclusion (FEIE):**
  - Expatriates which qualify may exclude the first $99,200 of “foreign earned income” in 2014. The FEIE increased to $100,880 in 2015, and to $101,300 in 2016.
    - Foreign earned (or foreign sourced) income: 1) Is earned from sources within a foreign country, 2) includes all compensation & wages, 3) is not based on how or where the payment of the income is made.

- **Housing exclusion:**
  - Expatriates which qualify (i.e. based on the bona fide residence or physical presence tests), may exclude for 2016, a maximum Housing Exclusion = 30% of $101,300 = $30,390 (Housing Exclusion Max), less 16% of FEIE = $16,208 (Base Housing Amount) = $14,182.
    - Example: Jim Smith’s Housing in Muscat, Oman is $30,000 during 2016. He will be able to exclude $13,792 of earnings as follows:
      - $30,000–16,208 = $13,792

- These exclusions do not apply to exempt an employee from FICA & Medicare.
IRS provisions to eliminate double taxation (cont.)

• **Foreign tax credits:**
  - Expatriates may take a credit relating to foreign sourced income on their US Income Tax Return for Foreign Income Taxes paid to the foreign tax authorities as required by law of the foreign country.
  - Some states do not allow foreign tax credits.

• **Totalization agreements (Bi-National Social Security Agreements):**
  - Purposes: To eliminate double taxation of Social Security & Medicare taxes, and to fill in gaps (i.e. by combining or “totalizing” S.S. coverage credits) when the employee has a divided career between the US and a foreign location.
    - Detached Worker rule: If employee is temporarily (5 years or less) working for the same employer in the foreign location, taxes are withheld/covered by Home Country
    - Example: Jim Smith, a US citizen is an Expatriate in the U.K. applies for and obtains a “Certificate of Coverage” from the SSA, which exempts him from U.K. Social taxes
    - US has signed special social security agreements with 26 countries
    - Recently entered agreements include the Slovak Republic effective May 1, 2014, and Hungary as of September 1, 2016.

• **Income tax treaties:**
  - In addition to eliminating double income taxation, the purpose of a Treaty is to clarify each country’s taxing jurisdiction, promote economic cooperation, and eliminate barriers to trade & investment.
  - Each country with which the US has a treaty, has different provisions
State Considerations for US Expatriates

Starting Point 1
• State Residents are liable for State income taxes based on their total income (including foreign sourced income)

Starting Point 2
• State taxable income usually begins with the federal Adjusted Gross Income (AGI) or taxable income (with some modifications)
Residence vs. Domicile States
An individual's state tax residency is determined independently of his/her Federal tax residency

<table>
<thead>
<tr>
<th>Resident State Taxation</th>
<th>Domicile State Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Based upon physical presence and tangible connections in the state for more than a temporary or transitory purpose, regardless of the employee's intent</td>
<td>• Based upon the employee’s true, fixed and permanent home to which the employee intends to return upon completion of the assignment.</td>
</tr>
<tr>
<td>• Some states may have clear guidelines on the number of days required to be spent outside the state to terminate residency</td>
<td>• Not changed by a temporary move to another location</td>
</tr>
<tr>
<td>• Some resident states may require meeting conditions commonly associated with domicile states</td>
<td>• Factors indicative of domicile include:</td>
</tr>
<tr>
<td></td>
<td>- bank accounts</td>
</tr>
<tr>
<td></td>
<td>- location of family</td>
</tr>
<tr>
<td></td>
<td>- business connections</td>
</tr>
<tr>
<td></td>
<td>- real property ownership</td>
</tr>
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<td></td>
<td>- voters registration</td>
</tr>
</tbody>
</table>

• To effect a change in domicile, the following must be present:
  - Change in intent
  - Change in physical location
  - Severance of connecting factors
  - Creation of new ties
  - Residency exceptions—“Bright Line Residency Test”
Breaking State Residency

• Whether determined by residence or domicile rules, residency in a state is very important because once residence is established, state has the right to full taxation

• Assignees leaving the US must establish that they have severed their residency in a state to avoid continuing to be subject to full taxation and withholding in that state while abroad

• This is particularly difficult in domicile states since generally the US outbound intends to come back

• Typical pitfalls
  – Family members remaining (college student generally OK, but spouse no)
  – Keeping a home available (not rented out)
  – W-2 shows state wages and/or withholdings
State Considerations for US Expatriates

• In setting up an employee on a Foreign Assignment:
  - Understand the State's definitions of a domiciliary & resident
  - Do they treat a non domiciliary as a resident (i.e. based on physical presence, permanent abode)?
  - Do they treat a domiciliary as a non-resident for tax purposes (i.e. California)?
  - Are the Foreign Exclusions allowed (i.e. Oklahoma–yes, Alabama–no)?
  - Is a credit or deduction allowed for Foreign Taxes Paid (i.e. Arizona)?
  - Is it a Community Property state (i.e. California)?
  - Are there De Minimus Thresholds (i.e. Days-AZ or Wage Minimum-OK)?
Basic types of Overseas Assignments:
Assignee Types

For US tax purposes, assignees are often referred to as:

- **Expatriate** = US citizen or legal permanent resident outside the US
- **Inpatriate/Alien** = Foreign national in the US
- **Third Country National (TCN)** = Foreign national outside the home country (no relation to the US)

Many companies are now global in nature and therefore may use terms that are more global in nature such as:

- **Global Assignees**
- **International Assignees**
## Differentiating Between Assignee Types

<table>
<thead>
<tr>
<th>type</th>
<th>Assignment Length</th>
<th>Intention</th>
<th>Other Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-term</strong></td>
<td>Assignment is generally greater than one year</td>
<td>Repatriate to home country at assignment conclusion or take subsequent assignment</td>
<td>Typically accompanied by family</td>
</tr>
<tr>
<td><strong>Short-term</strong></td>
<td>Assignment is generally one year or less</td>
<td>Repatriate to home country at assignment conclusion or take subsequent assignment</td>
<td>Typically unaccompanied</td>
</tr>
<tr>
<td><strong>Permanent Transfer</strong></td>
<td>No defined end date</td>
<td>Remain in the host location indefinitely</td>
<td>Typically accompanied by family</td>
</tr>
<tr>
<td><strong>Extended Business Travelers</strong></td>
<td>Trips are generally more than 30 consecutive days in length or high in frequency</td>
<td>Return to the home country between business trips</td>
<td>Typically unaccompanied</td>
</tr>
<tr>
<td><strong>Rotators</strong></td>
<td>Rotations are typically 21-28 days on/off at the work site for 2-3 years</td>
<td>Return to the home country during non-work periods and at the end of the rotational assignment</td>
<td>Typically unaccompanied</td>
</tr>
</tbody>
</table>
### US Payroll Reporting by Assignment Type

<table>
<thead>
<tr>
<th>Assignment Type</th>
<th>Description</th>
<th>Remuneration Status</th>
<th>Us Source Wages Reportable</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Expatriate</td>
<td>US citizen/resident status &amp; US employee</td>
<td>Taxable on most remuneration.</td>
<td>US source wages reportable on Form W-2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Wages are reportable on Form W-2. Note: IRC 3401(a)(8) exception.</td>
<td></td>
</tr>
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<td></td>
<td>Wages are reportable on Form W-2</td>
<td></td>
</tr>
<tr>
<td>US Inpatriate</td>
<td>US non-resident status and non-US employee</td>
<td>Taxable on US source remuneration.</td>
<td>US source wages reportable on Form W-2</td>
</tr>
<tr>
<td></td>
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<td></td>
</tr>
<tr>
<td>Long-term</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short-term</td>
<td>If tax home is maintained, most assignment allowances may be non-taxable and non-reportable. Wages are reportable on Form W-2</td>
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<td>If tax home is maintained, most assignment allowances may be non-taxable and non-reportable. US source wages are reportable on Form W-2</td>
</tr>
<tr>
<td>Permanent Transfer</td>
<td>Most would not remain a US employee. Post-transfer compensation may not be reportable on Form W-2. Note: IRC 3401(a)(8) exception.</td>
<td>Most will become US employees. Pre-transfer compensation may not be reportable on Form W-2</td>
<td>Taxable on US source remuneration. US source wages are reportable on Form W-2</td>
</tr>
<tr>
<td>Extended Business</td>
<td>If tax home is maintained, most benefits may be non-taxable and non-reportable. Wages are reportable on Form W-2</td>
<td>If tax home is maintained, most assignment allowances may be non-taxable and non-reportable. Wages are reportable on Form W-2</td>
<td>If tax home is maintained, most assignment allowances may be non-taxable and non-reportable. US source wages are reportable on Form W-2</td>
</tr>
<tr>
<td>Travelers</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Rotators</td>
<td>Taxable on most remuneration. Wages are reportable on Form W-2</td>
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<td>Taxable on US source remuneration. US source wages are reportable on Form W-2</td>
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<td></td>
</tr>
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</table>
Assignment Payroll Set-up Basics

Most assignees will receive allowances of benefits that relate to the overseas work assignment. These payments are in addition to their normal base remuneration package (e.g. base salary, bonus and equity). Typically, allowances, differentials and deductions will be made via payroll.
Tax Equalization and Hypothetical taxes:
### What is Tax Equalization?

<table>
<thead>
<tr>
<th>Tax Equalization defined—WHAT</th>
<th>• An internal company policy (i.e. versus IRS or statutory code)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The policy’s objective—WHY</td>
<td>• For the assignee to be no better off or no worse off from a Tax standpoint while on a foreign assignment, than if he/she never left their Home Country</td>
</tr>
<tr>
<td></td>
<td>• That each assignee pays their fair share of Income &amp; Social Taxes</td>
</tr>
<tr>
<td></td>
<td>• To make taxes a neutral factor when calculating an employee’s foreign compensation package</td>
</tr>
<tr>
<td>The vehicle—HOW</td>
<td>• Hypothetical Tax Deductions (in lieu of FIT), and a Tax Settlement Calculation (TSC) or a Tax Equalization Calculation (TEQ) prepared upon completion of US tax returns</td>
</tr>
<tr>
<td>What does the employee pay?—HOW</td>
<td>• Approximately the same amount of taxes as if they were still living &amp; working in the US i.e. Taxation on salary &amp; bonuses less pre-tax deductions (Stay-at-Home Comp)</td>
</tr>
<tr>
<td>What does the Company pay?—HOW</td>
<td>• All foreign income tax liabilities, and any US tax liability over and above the employees responsibility, which is usually due to taxation on foreign allowances, relocation, etc. (i.e. Non Stay-at-Home Comp)</td>
</tr>
</tbody>
</table>
Hypothetical income tax deduction—What is it?

- Utilized in sync with Company’s tax equalization program—i.e. every assignee should pay their fair share of Income taxes. They should no better or no worse off than if they remained in their Home Country

- Hypo tax is an employee income tax deduction in lieu of regular US Tax withholdings (i.e. FITW, SITW)
  - NEW: Although typically in lieu of a Federal Income Tax, the employer may take a Hypothetical State Tax depending on their Tax Equalization policy.

- Is not based on a W-4 form but is calculated by the Company or a third party similar to the way that FIT & SIT is calculated, and considers Company approved assumptions on itemized deductions, child tax credit, etc.

- Calculation is based on regular or base salary considering exemptions and pre-tax deductions (i.e. 401k, pre-tax med/dental and non-qualified deferred comp plans)
Hypothetical income tax deduction—What is it? (cont.)

- Hypo tax is also withheld at supplemental rates on supplemental payments such as bonuses & equity compensation.

- **Should be considered as a negative earnings vs. a payroll deduction.** Said another way: taxable wages should be reported net of Hypo tax w/h,

- Hypo tax is not remitted by the company to any US tax authority but is retained by the company (i.e. goes back into the company’s pocket),

- Hypo tax (i.e. negative earnings) should be credited to the same accounting home (i.e. company, account, cost center) as the base salary or supplemental payment in the general ledger.

- Hypo tax commences and the Federal Income Tax (FIT) is discontinued as the assignee will be eligible for certain exclusions & a credit against their FIT on Foreign Earned Income (i.e. FIT liability may be reduced or eliminated) due to the FEIE, housing exclusions, foreign tax credits, etc.
Hypothetical tax—Why? (cont.)
Background on discontinuing FITW/SITW:

- **FITW**: US/foreign employers are required to withhold and report FIT from compensation of US citizens or residents (regardless of where it is paid from).

- **Exception**: Internal Revenue Code (IRC) Section 3401 allows an employer to discontinue an employee’s FITW if they:
  - Qualify for the FEIE and the Housing exclusion (IRC Section 911), or
  - Their wages are subject to foreign income tax withholding on earnings and benefits/allowances received in country.

- **Use IRS Form 673** to discontinue withholding (on wages that qualify for the exclusions) for employees qualifying for foreign earned income & housing exclusion.

- **Use IRS Form W-4** to discontinue withholding on wages in excess of $101,300 in 2016 if employee is also subject to foreign tax withholding. Note: IRC 3401(a)(8) exception.

- **Safe harbor payments**: A federal or state tax payment made by the company on behalf of the employee to reduce underpayment penalties & interest.
Mirror or shadow payrolls—when, what, why & how?
Overview of Mirror Payrolls

What?
• A payroll in the host country which is intended to reflect or “mirror” the actual payroll being paid from the home country
• Also known as “shadow” or “ghost” payrolls

When?
• A payroll is established in the host country (i.e. US) when the assignee is being paid from the assignee’s home country
• If an employee remains on their home country payroll, and there is a reporting/withholding requirement in the host location, then a mirror will be required in the host location.

Why?
• It is set up in the host location for purposes of:
  − Compliance: Calculating & remitting Host Country Income & Social Taxes,
  − Reporting: Producing a W-2 or host Country equivalent,
  − Tax return prep: Expedites the host country tax return process.
Overview of Mirror Payrolls (cont.)

- Earnings in the home location are reported in the Host country’s payroll similar to a regular employee of the host country.

- Calculate monthly payroll for assignees with all applicable tax gross-ups and set up in the host country payroll system

- Obtain review & approval from Corporate tax & legal department, as impacts existing or new Federal EIN’s

- There should be no general ledger impact of this mirror payroll other than the charging out of the tax gross-ups which are considered as additional earnings to the assignee

- Establish an offset to the earnings (being paid in the Home Country), such that
  \[ \text{Net Pay} = 0 \]

- All applicable taxes should be remitted to the host country tax authorities

- If the Host country is the US, State & Federal unemployment should be established
Foreign compensation collection—How does it impact payroll?
Purpose for process

Purpose: To comply with US IRS Payroll and Tax Code (i.e. Report Worldwide Income), Host Country Tax and reporting requirements, and Company cost control and reporting requirements

1. **US compensatory or taxable costs:**
   Collect from the foreign locations any assignee costs paid on behalf of, or reimbursed to the assignee in the foreign location (i.e. items paid in local currency not already in the payroll System) deemed to be US taxable

2. **Total costs:** Collect from the foreign locations all assignee costs paid on behalf of, or reimbursed to the assignee in the foreign location (i.e. items paid in local currency not already in the payroll System) which are both US taxable and non-US taxable

3. **Foreign country reporting:** Even though US tax law may exempt a payment from US taxation, the foreign country may deem it to be taxable (so keep on PLS reports and make sure the covar is non-taxable for US reporting):
   - Moving expenses
   - Per diems or other short-term assignment expenses
Compensation Collection Process
What should you expect to see reported outside payroll?

- Travel costs: home leave, R&R, dependent travel
- Relocation payments: pre-assignment trip, temporary living, shipping, travel
- Foreign income and social security taxes (if applicable)
- Dependent education costs
- Housing and utility costs in the host country
- Auto or transportation costs
Collection of Foreign Earnings and Total Cost Reporting

• Assignee costs should be differentiated or split between:

  – **US taxable vs. Non US taxable:** For W-2 & Tax preparation purposes,

  – **Costs that the company will not tax protect (Stay-at-Home) vs. costs that the company will tax protect (Non stay-at-home):** For Tax equalization calculation & policy purposes,

  – **Foreign sourced vs. domestic or US sourced earnings:** For purposes of utilizing the Foreign Earned Income Exclusion as well as foreign tax credits, and for W-2 state wage purposes.
Expatriates to the US (AKA “Inpatriates” or Foreign Nationals to the US, or Resident Aliens and Non Resident Aliens)
A Framework for Inpatriates or Foreign Nationals

Under immigration law
- Immigrants
- Non immigrants
- Illegal aliens

Under US Tax Law
- Resident aliens
- Non resident aliens
Under immigration law

**Immigrants**

Examples include:
- Aliens who have been granted the right to legally reside permanently in the US
- Permanent resident aliens, or
- Lawful Permanent Residents (LPR’s)
- Green card holders

**Non Immigrants**

- Aliens who have been granted the right to reside temporarily in the US (i.e. For tax purposes, these may be Resident or Non-Resident Aliens)
- Entry into the US is on a nonimmigrant visa
- Depending on the visa status:
  - Employment may or may not be permitted
  - There are strict time limits
  - Certain rules must be followed
Under tax law

- **Green card test:** Lawful Permanent Residents (LPR) or green card holders
- **Substantial presence test:** A numerical formula for counting days present in the US over a 3 year period:
  - **31 Day Test:** Must be in the US for 31 days during the current year, AND
  - **183 Day Test:** Days in current calendar year + 1/3 days in first preceding year + 1/6 days in second preceding year must equal 183 days

- Both the 31 & 183 day tests must be met to be considered a “Resident alien”.

- Resident aliens are income taxed on Worldwide income, and are FICA/Medicare taxed the same as US citizens (with some visa exemptions), regardless of where paid or earned.

- **“Closer Connection” Exception:** Aliens who qualify under the substantial presence test may be considered as non residents if they can demonstrate based on facts & circumstances (i.e. days, tax home), that they have a “closer connection” to a foreign location than to the US
Under tax law
Module 5: Expatriates to the US

- Do not meet the 31 or 183 day substantial presence test,
- Are taxed in the US only on their earnings from US Sources (regardless from where it is paid),
- Are liable for fed & state inc tax w/h on wages unless exempt due to a Tax Treaty and Statutory exemptions
- Are liable for FICA/Medi/FUTA/SUTA taxes on wages unless they are on certain visas (i.e. typically F & J visas), or in the case of FICA/Medicare, are from a country with a totalization agreement with the US
- Commercial Traveler Exception: Non Resident Alien spends < 90 days in US, and earns less than $3,000 during the taxable year. The NRA must be employed by a US employer in a foreign Country, or a foreign employer not engaged in in trade/business in the US
- May only claim single filing status on W-4. Generally cannot claim > one exemption on the W-4. Cannot claim “exempt” on line 7 of the W-4,
- Must write “Nonresident alien” or “NRA” above dotted line on line 6 of W-4,
- For wages subject to FIT W/H, additional amounts prescribed by the IRS must be added to wages for purposes of calculating FIT W/H,
- Tax Exempt wages (under a tax treaty) and “non wage” payments to NRA’s must be reported on forms 1042 and 1042-S, and on a W-2 for State & Local Income taxes. Wages that are not Tax Exempt should be reported on a W-2 (i.e. Fed, State & Local). Other required forms include Forms 8233, W-9 and possibly a W-8 BEN.
Under tax law

- Part Year Resident/Part Year non Resident.
- Taxed on Worldwide Income on Residency Period (i.e. While a Resident Alien), and Taxed only on US Sourced Income during the non residency period (When they are a Non Resident Alien).
- Applies to years of arrival & departure.
US state taxation: US inbound assignments

State residency

• Assignees are typically taxed in the state where residency/domicile is established.

• If state residency is not established, assignee may still be subject to tax on income earned or from sources within the state.

Domestic business travel

• Working in other states may result in multi-state filing requirements.

• In most states, a credit is available for taxes paid to another state; a credit may not be available for taxes paid to another country.

• A state may not adopt federal rules and methods, and may not recognize federal treaty provisions.

⚠️ Many states tax residents on worldwide income
Common types of non-immigrant visas:

- B-1: Temporary visitor for business & pleasure
- F-1: Academic student
- H-1B: Specialty occupation
- J-1: Exchange visitor visa
- L-1: Intra-Company transferees
  - L-1A: Intra Company transferees—Executive, managerial
  - L-1B: Intra Company transferees—Specialized knowledge
- TN: Canadian & Mexican citizens/professionals
Questions?

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