

International assignment perspectives — *special alert*

Proper accounting and budgeting for tax equalization costs — a practical and accurate approach

In this Special Alert, author Jim Muth expands on his recent article, “Eliminating the Surprise: A practical and accurate approach to tax equalization costs,” which described an approach to budgeting for assignment costs. While the approach described by Jim is certainly not the only approach companies can use to budget for these costs, it is one way to minimize unexpected expenses at the end of an assignment. Below, Jim provides us with a detailed example of how this methodology can work.

In this example, please assume the following facts. For these purposes, the focus will remain on budgeting for the tax equalization costs only:

- John Smith, his spouse and two children are starting a three-year assignment to Singapore on January 1, 2008. John is based in NJ.
- He will be tax equalized to NJ and the Company uses the current year method of reimbursement.
- Initial assumption is that John will receive annual salary increases of 3% and he will earn bonuses targeted at 25% of base salary annually.
- John will receive housing accommodations, cost-of-living allowance, a mobility premium and relocation allowance.
- The Company defines tax equalization costs as home tax costs plus host tax costs less home hypothetical tax.
- Company reviews accruals once annually.

Based on John’s facts and circumstances, his employer uses a tax cost projection system to determine his pre-assignment tax equalization costs and arrives at the following:

	2008	2009	2010	Total
Home Tax	75,627	77,492	81,491	234,610
Host Tax	66,706	67,506	71,676	205,888
Hypo Tax	(77,290)	(80,519)	(83,843)	(241,652)
Total	65,043	64,479	69,324	198,846

Therefore, under this methodology, the Company would accrue monthly tax equalization costs of \$5,524 (\$198,846/36 months). At the end of year one, the accrued liability would be \$66,282.

End of year one

After year one is completed and final total compensation is known (or tax returns have been completed and filed), the Company will “true up” the original calculation to determine what changes are to be reflected. In this example, it is assumed the only change after year one is that the bonus paid was actually 30% of base salary. As a result, the updated calculation will reflect all the same information, except bonuses will be projected at 30% vs. 25%.

After revising the bonus amounts in the projection, total tax equalization costs for the three-year assignment are projected at \$197,382. This seems reasonable given that the higher tax costs will generally be absorbed by the employee since tax on bonuses are liable for hypothetical tax.

The adjustment to the accrual will be reflected as follows:

\$197,382	Revised total tax equalization cost projection
<u>(\$66,282)</u>	Amount accrued to date
\$131,100	Amount to accrue over remainder of assignment (24 months)
<u>24</u>	Remaining assignment months
\$5,463	Revised monthly accrual starting in year two

In addition, once actual taxes and hypothetical taxes are paid/deducted, these amounts will be applied against the accrual. After year one, actual tax equalization costs are \$64,234. This will offset the accrual and also be reflected in any further revised tax cost projections as well. The expected balance by the end of year two should be \$67,598 (\$66,282 year one accrual, \$65,550 year two accrual, less \$64,234 actual costs applied against accrual).

End of year two

During year two, John is rewarded for having done an extraordinary job and is promoted, receiving a substantial increase (over the budgeted 3%). In addition, John's son has enrolled in an American school for which the Company will pay tuition. As a result, the Company will need to reflect these changes in the year two "true up."

Once the actual compensation and known actual tax equalization expenses are reflected into the new calculation, the projected total tax equalization costs for the three-year assignment are \$226,825. This seems reasonable given the level of additional Company assistance (children's education for two years).

The adjustment to the accrual will be reflected as follows:

\$226,825	Revised total tax equalization cost projection
<u>(\$131,832)</u>	Amount accrued to date
\$94,993	Amount to accrue over remainder of assignment (12 months)
<u>12</u>	Remaining assignment months
\$7,916	Revised monthly accrual starting in year three

The higher amount reflected here is due to two factors—it appears that additional hypothetical tax was not deducted at the time of the promotion and the unforeseen child education costs. Of course, if factored in, the accrual would be averaged further. Again, once actual taxes and hypothetical taxes are paid/deducted, these amounts will be applied against the accrual. After year two, actual tax equalization costs are \$78,484. This will offset the accrual and also be reflected in any further revised tax cost projections.

End of year three

After the assignment is completed, a final reconciliation may be done with the final tax equalization. Assuming that there are no further extraordinary compensation items, the Company will generally not revisit the accrual and await the final tax equalization expenses derived from the tax returns and tax equalization settlement.

In this example, the bonus amount was a little higher than target, meaning that the employee will generally fund the increase as it is subject to hypothetical tax. The final tax equalization costs are \$225,435. Reviewing the tax equalization liability account, the balance should be as follows:

\$66,282	Year one accrual
\$65,550	Year two accrual
\$94,993	Year three accrual
<u>(\$64,234)</u>	Year one actual costs
<u>(\$78,484)</u>	Year two actual costs
<u>(\$82,717)</u>	Year three actual costs
\$1,390	Balance in accrual account

As you see, the balance at the end of assignment is nominal. Of course, the review of hypothetical tax revisions and more frequent revisiting of the projections can further reduce timing issues, depending upon the Company's level of tolerance and resources. However, as in this example, annual review of tax equalization costs and revision of the projection will help minimize any tax equalization cost surprises. Of course, while there are several different approaches that companies can use to manage assignment cost budgets, the methodology used in this example can help minimize surprises at the end of an assignment. To read the original article, visit www.pwc.com/iaspectives2 to download.