

International assignment services

International assignment perspectives

Critical issues facing the globally mobile workforce

Volume 4



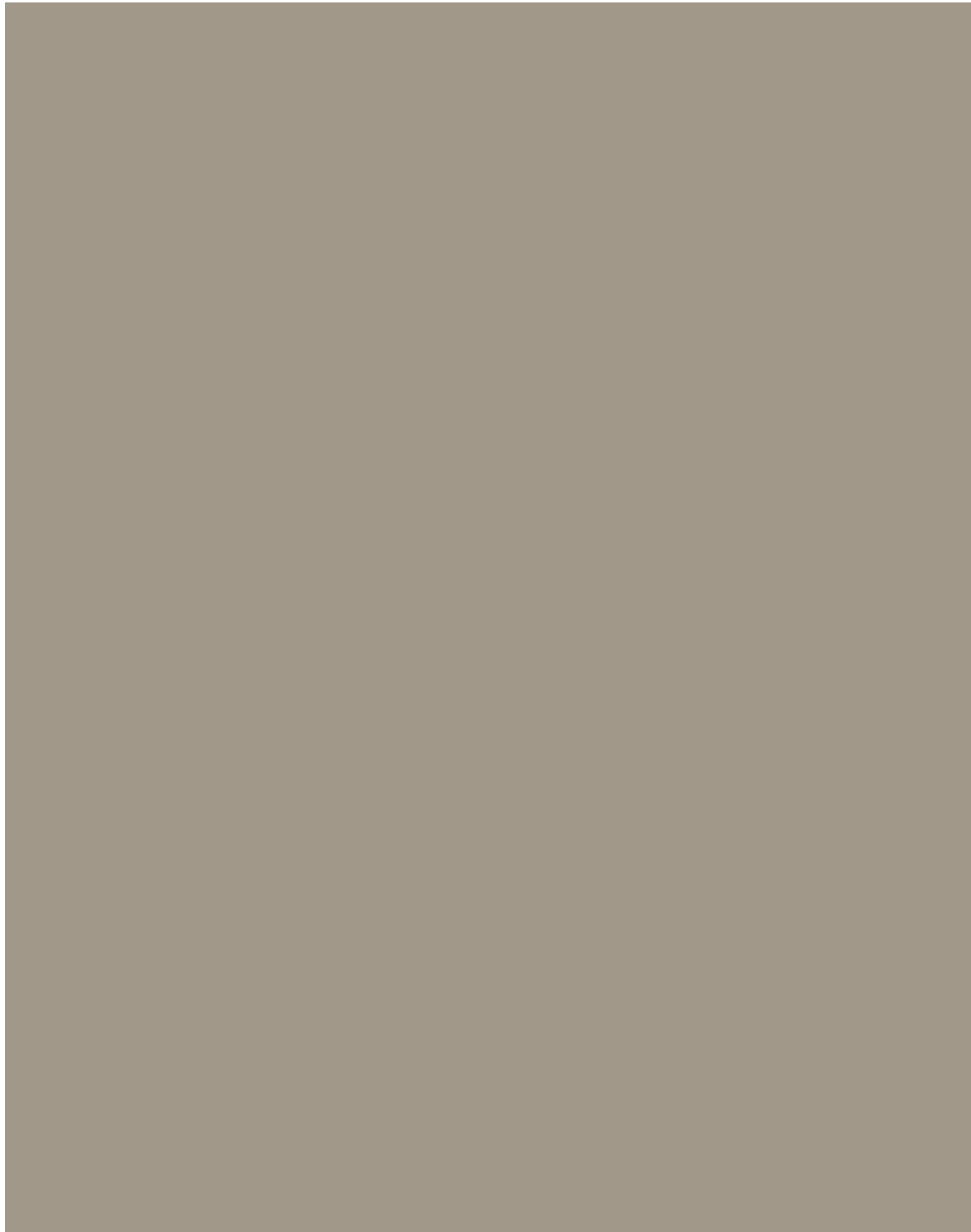
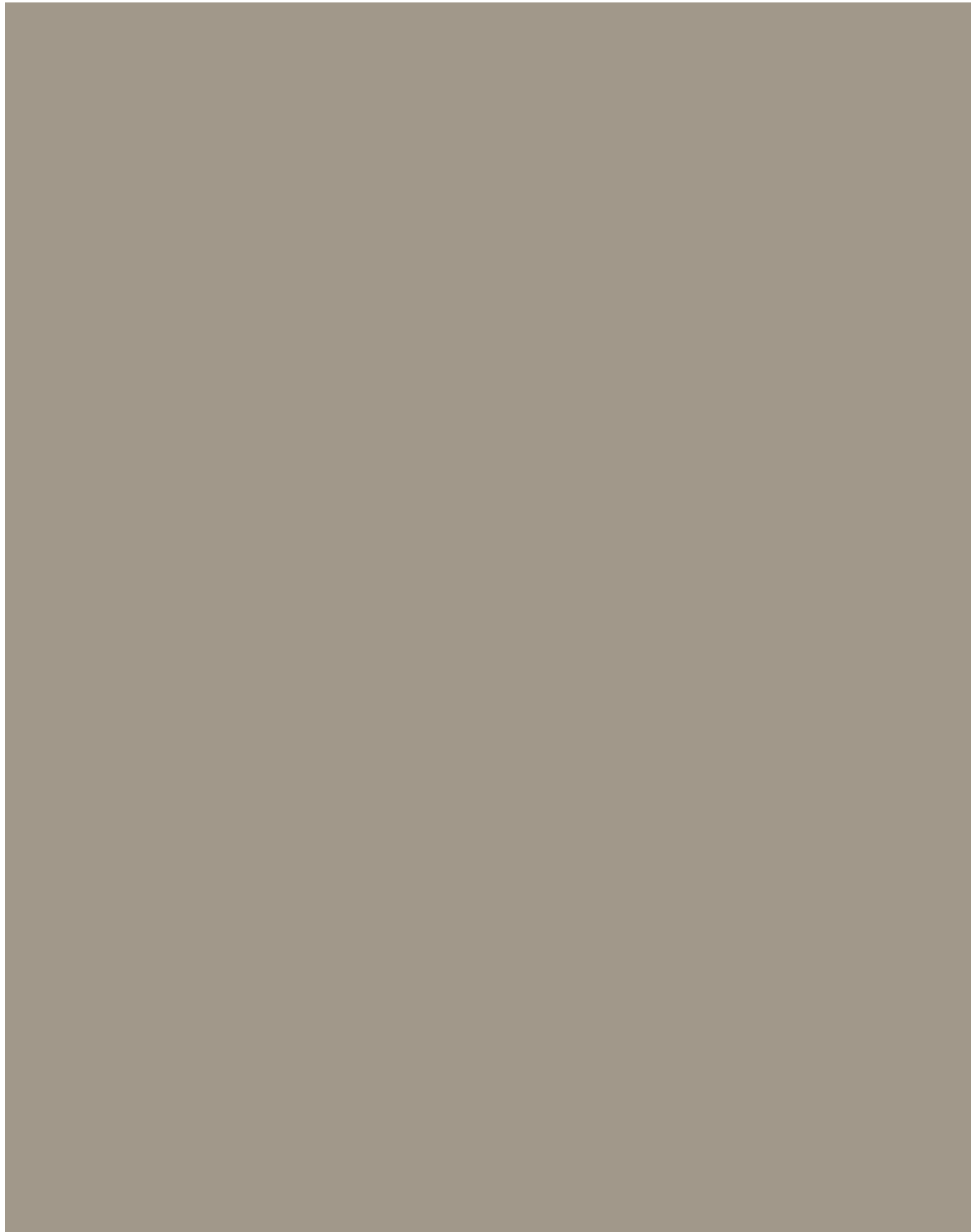


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Foreword

The primary issue facing global organizations is getting the right skills, in the right place, at the right time. As a result, the nature of international assignments has grown more complex over the years. We have seen international assignments evolve from largely long-term assignments given by large multinationals into a new breed of mobile workers who go beyond the traditional expatriate assignments to meet the growing demands of globalization.

Despite the negative economic climate of today, every facet of business remains impacted by increased globalization. Knowledge, trade, technology, capital, and goods and services are more globally connected than ever. Coupled with the rise of emerging markets and the focus on new revenue streams, we can expect to see a continued swell in global worker mobility.

Naturally, this influences global mobility programs and policies. International mobility is an intensely strategic issue, and getting it right means mastering the tax implications, building attractive propositions for candidates, and developing effective return programs. All too often, companies take their eye off the ball while employees are away on assignments. As a result, approximately one-third of assignees resign within 12 months of completing an assignment—an unfortunate waste of investment and talent.

Organizations need to stay on top of the fiercely competitive market for global talent by retaining the knowledge and ability to address the various challenges that await their globally mobile workforce. *International assignment perspectives—volume 4* is a collection of thought leadership articles that explore current issues requiring the attention of today's HR leaders and tax directors who manage a globally mobile workforce. We hope you find the fourth edition in the series an insightful and innovative read that presents answers to your key questions and provides a strategic framework for addressing today's challenges in international assignments.

A handwritten signature in black ink, appearing to read "Billy", written in a cursive, stylized font.

William F. Owens, Jr.
Global Practice Leader
International Assignment Services



The first line of defense

Avoiding overseas tax exposure and the implications
of permanent establishment status

Carol Neumeister and Sunita Suri

Successful competition in the global marketplace can require companies to deploy employees abroad at a moment's notice. Human resources (HR) professionals, who often decide the structure of these global assignments, play vital roles in ensuring the assignments occur as cost-effectively as possible.

Therefore, it is imperative for HR professionals to develop and maintain a working understanding of the individual and corporate tax implications of sending employees on international assignments. Armed with that knowledge, HR professionals can draw on expert resources to help them design assignments that minimize individual and corporate tax costs.

This article informs HR professionals by highlighting several of the major corporate tax issues that arise from moving people across borders. It also delves into the meaning and implications of permanent-establishment (PE) status for companies operating abroad and offers some suggestions on how businesses can reduce PE risk.

Global market, local tax risk

International business is becoming seamless, evolving toward a single global marketplace that transcends national borders. However, tax authorities across the globe still manage their revenues on national, jurisdictional, or territorial bases.

This built-in regulatory and tax friction poses challenges for companies as they try to meet global demand for their products or services by deploying human capital internationally.

Understanding *permanent establishment*

The US government taxes the worldwide income of its corporate residents, meaning that a US-based company generally pays US taxes on both its domestic and its international profits. Foreign countries may also reserve the right to tax income that the US company earns in the foreign jurisdiction.

The US has bilateral income tax treaties with many global trading partners. Under the terms of those treaties, a company that establishes a taxable presence in a foreign country is understood to have created a permanent establishment. With few exceptions, a treaty must exist between the US and the foreign country for the concept to apply.

In the absence of an income tax treaty, a company may unknowingly establish a taxable presence under the definition enforced by the local tax laws and practices of the foreign country. It generally takes a much lower threshold of activity to establish a taxable presence than to establish a PE in a foreign country.

The Organisation for Economic Co-operation and Development (OECD) model tax treaty defines a PE as “a fixed place of business through which the business of an enterprise is wholly or partly carried on” or “an agent acting on behalf of the enterprise who habitually exercises the authority to conclude contracts binding on the enterprise.”

In determining whether a fixed place of business exists, an authority considers whether the company's operations reflect permanency or temporary use of a fixed base.

Examples of a fixed base may include but are not limited to branch offices, management centers, factories, workshops, and mines or other sites of natural extraction.

Facilities used for short-term business activity (less than 12 months) may not result in a PE. They include short-term building sites, construction or installation projects, drilling rigs, and ships used for exploration of natural resources.

Even if a company does not utilize a fixed place of business in a foreign location, the company may have a PE when certain activities are pursued by an agent or other person acting on behalf of the company. Generally, such an agent constitutes a PE if he or she has the authority to conclude binding contracts and uses this authority habitually. Determining what constitutes an “authority to conclude contracts” varies depending on the individual treaty.

A US company will be subject to tax in a foreign country if the company has a PE or, in nontreaty countries, a taxable presence in the foreign country. Creating a PE or taxable presence can be an expensive proposition, given the potential for double taxation, the administrative costs of registering in a foreign country, and the cost of complying with the various reporting requirements.

The details of what constitutes a PE, or how a company establishes a taxable presence in a foreign jurisdiction, are complex, and HR professionals do not need to fully understand every nuance. However, it is important that they recognize that the company might create a PE by sending an employee abroad and that they will need to address the structure of the assignment with the company’s tax, legal, and business professionals.

Other PE risks

In relying on the dependent-personal-services article of a bilateral income tax treaty, many companies assume that if their employees do not stay in the foreign country for more than 183 days, the employees will not be

subject to tax in that country. That may not be true. Yet many companies and HR professionals overlook this critical detail.

Depending on the particular treaty, the dependent-personal-services article may contain a provision that disregards the 183-day rule if the employee’s compensation is “borne by” a PE or other entity in the foreign country. When an applicable treaty contains this provision and the company has a PE in the foreign country, the employees are generally subject to income tax in the foreign country from the first day of service. This may add significant additional costs to the project.

Mitigation options

The establishment of a PE or taxable presence depends on the facts and circumstances of each project or deployment. Therefore, avoiding or mitigating tax consequences requires careful communication and coordination between the HR, legal, finance, accounting, and tax departments and the business developers.

Without proper communication between all of the relevant parties within the company, a poorly structured employee transfer to another country could create a corporate tax presence in the foreign jurisdiction. And the US company could then be required to file a return and pay taxes in a foreign country.

Setting general PE risk policies

To cope with the PE or taxable presence issues created by cross-border projects, many companies set general guidelines for when PE or taxable presence exposure must be considered in budgeting for business expansions and assignments.

For example, some companies choose to ignore the PE or taxable-presence exposure in situations where the expected revenue stream is less than \$1 million. Other companies may choose to ignore the PE or taxable-presence exposure for projects lasting less than six months. In either case, the company should review its risk tolerance policy and make practical decisions to balance the costs and risks associated with global projects.

Using secondments to reduce PE risk

Sometimes, where a PE or taxable presence is likely to occur and the company has an affiliate in the foreign jurisdiction, some companies “second” —or lend—their employees to a local affiliate. This can help avoid a PE or taxable presence for the US company. Known as a secondment, under such an arrangement the employee remains on the home country payroll and continues to enjoy home country benefits. However, the employee in such a case is under the direction and control of the local affiliate.

Under a secondment arrangement, the local affiliate in the host country will typically bear all the risks and rewards associated with the local business and the assignment. The local affiliate is responsible for local country tax on the income associated with the business. The US company receives a secondment fee for lending its employees to the local affiliate.

Recent developments in secondment law

Multinational companies have relied on secondments for many years as a way of minimizing the risks from creating a PE. However, secondments may not work for reducing the risk of creating a PE in all countries.

Skepticism in China

Recently, a number of local Chinese tax bureaus—including Shanghai, Beijing, and Guangzhou—have started to scrutinize international employee secondment arrangements.

The tax bureaus believe that some multinational companies are using secondment arrangements to avoid Chinese taxes for projects undertaken by the foreign home entities for the local host entities in China. And the tax authorities argue that a secondment may represent an unincorporated presence for the home entity taxable in China under the PE rules.

One particular point of focus involves salary payments cross-charged to the Chinese entity as fees for services rendered by the home country’s seconded employees to the Chinese host. The tax authorities consider these as fees for services that are subject to Chinese taxes. In an attempt to gather information in support of the taxable-PE argument, Chinese tax authorities surveyed a number of foreign investment enterprises using secondees.

Indian Supreme Court weighs in

In a recent case involving Morgan Stanley, the Indian Supreme Court ruled that no PE is created for a foreign entity when the foreign entity sends an employee from the home location to India to carry out a stewardship function. That stewardship function reflects a short-term assignment designed to ensure quality control based on the home country entity’s standards.

However, the court also recognized another class of employees—called deputationists—who are sent from the foreign entity on deputation, which is, essentially, the same as a secondment. These employees might create a PE in India because the foreign entity is responsible for the work performed by these employees and because such employees remain on the home country payroll.

However, the court noted that even if such employees create PEs, no profit would be attributed to the PE so long as the foreign entity is compensated at arm's length. The multifaceted Indian ruling should spur companies to scrutinize the activities of employees working in India on their behalf. And the ruling demonstrates how important it is to communicate with the tax authorities and the business developers in order to address the specifics of cross-border assignments.

Conclusion

With today's proliferation of the global workforce, it is common practice for a company to engage employees to perform services for the company in foreign locations, thus creating PE exposure in those foreign locations.

It is clear that the existence of a PE creates an income tax exposure in the host country. However, determining the existence of a PE isn't always a clear-cut process. In an environment where taxing authorities are aggressively asserting the existence of a PE, it is vitally important that HR professionals understand and consider this potential tax exposure and that they work with their tax and business colleagues to address such issues in advance of assignments.



Brazil: The “B” of the BRICs

Jorge Morazzani and Débora Bigio

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Brazil is one of the four so-called BRICs, an acronym for the fast-growing economies of Brazil, Russia, India, and China. The BRICs account for more than 20% of the world's land area and more than 40% of the world's population. These countries are developing rapidly, and many say that during the next few decades the combined economies of the BRICs could surpass the economies of today's richest countries.

Recognizing that the BRICs offer huge business opportunities, global companies are paying increased attention to these markets, and Brazil is no exception. Thus, the importance of international assignments to and from Brazil has become more relevant.

General overview of Brazil

Brazil is a democratic federal republic with a population of 192 million, is the fifth-most-populated country in the world, and covers an area of 8.5 million square kilometers (3.3 million square miles). In geographic size it is also the fifth-largest country in the world and represents 47% of the South American continent. Its geography has a varied landscape, a diversity of wildlife, and an abundance of natural resources. The best example of Brazil's natural wealth is the Amazon rain forest, which comprises 3.6 million square kilometers (1.4 million square miles).

Economic environment

Brazil is the economic leader of Latin America and the only Portuguese-speaking country in the region. Its economy is the second largest in the Americas (after the United States) and one of the top 10 in the world. In fact, economic indicators suggest Brazil is the first Latin American country emerging from the recession.¹

Due to its distinctive position in South America, coupled with several government initiatives, Brazil has been a focal point for foreign investors. To improve its global economic status, Brazil has lowered interest rates, promotes partnerships between the public and private sectors (i.e., public-private partnerships), and participates in various multinational economic groups such as Mercosul, G-22, and the Cairns Group (a group of agricultural exporting countries).

As a result, Brazil has continued to progress in a number of industries, including nuclear and space programs, aircraft manufacturing, nanoscience and nanotechnology, and biotechnology. Agribusiness is responsible for 34% of Brazil's gross domestic product, 37% of national jobs, and 43% of national exports. Additionally, Brazil has the technological capacity for deep-sea oil exploration.

Ambassador for international sports

Brazil's global visibility was further enhanced after it was chosen as host for both the 2014 World Cup and the 2016 Olympic Games. Both events are expected to give rise to substantial construction and infrastructure investments, particularly because the Fédération Internationale de Football Association (International Federation of Association Football, or FIFA) and the International Olympic Committee impose strict infrastructure requirements. The increased economic activity will require additional technological resources and specialized professionals, and it is projected to bolster international assignments to and from Brazil.

Planning international assignments

Companies looking at international assignments to Brazil should consider a myriad of local aspects. Foreigners hired as employees in Brazil are subject to the same rules as Brazilian employees—namely, labor laws, social security laws, and Brazilian Federal Revenue

¹ *The Economist*, "Brazil is one of the first G20 economies to emerge from recession," September 14, 2009.

Department laws. In addition, foreigners working as directors of Brazilian companies are subject to the laws of the National Social Security Institute and the Federal Revenue Department, as well as the Civil Code and the Stock Corporation Act.

Individuals assigned outside Brazil also face a number of unique issues related to international deployment, including work contract revisions or rescissions and guarantees of jobs upon repatriation. They must also consider whether to remain on the Brazilian payroll, where and how wage payments would be made, applicable payroll taxes and taxes withheld, and related matters.

Therefore, companies deploying personnel to or from Brazil should analyze all relevant aspects of these assignments, particularly Brazil's immigration requirements, labor laws, and local and national tax systems.

Immigration

Brazilian companies hiring foreign individuals must comply with local visa and work permit requirements. Foreigners are allowed to work in Brazil only under one of the following types of visas:

- Permanent visa—generally applicable to investors, administrators, managers, directors, and executives with management powers who will occupy decision-making positions at any Brazilian company
- Temporary visa type V with a local employment contract—granted to foreigners hired as regular employees by Brazilian companies
- Temporary visa type V without a local employment contract—applicable to foreigners who render technical assistance services and technology transfer; requires a technical service agreement between a foreign and a national company and does not allow for an employment contract with a Brazilian employer

To obtain these visas, specific documentation is required, including proof of suitable qualifications to work in Brazil. To protect the local job market, work visas are issued only if the remuneration to be paid to a foreigner in Brazil is equal to or higher than the highest remuneration paid by the Brazilian employer to a Brazilian individual for the same position. Brazilian companies are allowed to pay compensation solely to those foreigners holding one of the first two aforementioned types of visas. The third type (temporary visa type V without a local employment contract) does not allow the individual to have an employment contract with a Brazilian employer, so it does not allow the individual to receive remuneration in Brazil.

According to a survey recently conducted by Brazil's Labor Ministry,² 42,914 job authorizations were granted through December 2009. The countries that sent the most foreigners to work in Brazil were the United States, the United Kingdom, the Philippines, India, and France.

Interestingly, during 2008 foreign private individuals invested in Brazil close to \$100 million and approximately \$33 million up to June 2009. Those figures show that foreign jobs in Brazil should be perceived not narrowly as competition with the local workforce but as an important source of foreign investments.

Labor law

Brazilian labor legislation is renowned for its protective nature. Brazil guarantees its foreign employees all of the rights granted to local Brazilian employees. In fact, labor rules generally are applicable within Brazil's national territory irrespective of the nationality or domicile of the parties. Additionally, labor rights cannot be waived by an employee or denied by an employer; therefore, employees cannot be harmed by an employment relationship. When companies plan international assignments to Brazil, it is important that they consider labor law ramifications, particularly those that could trigger potential incremental costs.

2 Brazil's Labor Ministry, <http://www.mte.gov.br>.

Typical benefits

All Brazilian workers have the right to access the government severance indemnity fund for employees, and employers must contribute 8% of an employee's salary to this fund. In case of dismissal without cause, an employee may withdraw the balance in this fund. The employer must pay the employee—as part of the termination payments—an amount equivalent to 40% of the balance distributed. In addition, the company must pay an additional fine to a government social fund equivalent to 10% of the balance distributed.

Employees of Brazilian companies are also entitled to vacation time. An employer must grant a mandatory 30-day rest period to an employee after the employee has rendered services for 12 months. An employee on vacation is entitled to receive regular pay plus an additional so-called vacation bonus equal to one-third of the monthly remuneration. Total remuneration (i.e., base salary and any other additional compensatory items such as bonuses and fringe benefits) must be considered in the quantification of vacation payments.

Also, an employer is required to pay an employee an annual so-called 13th salary (i.e., a Christmas bonus) payable to an employee regardless of the employee's amount of remuneration. The 13th salary is equivalent to one additional month of salary after taking into consideration annual or semiannual bonuses and fringe benefits. The employer must make half of the payment in November (or together with vacation if requested by the employee) and the other half in December.

Because Brazil does not allow its employers and employees to negotiate legal rights, it is imperative to consider local law during formalization of the remuneration package of an individual being assigned there. For example, the employer may consider apportioning an employee's annual base salary over

13.33 payments (i.e., 12 monthly regular payments plus the 13th salary plus the one-third vacation bonus) to minimize or avoid the incremental cost of the required 13th payment. Also, employers should clearly state whether certain income items should not be so-called tax equalized and, for example, consider as a matter of policy not tax equalizing severance benefits.

Recent developments

Brazilian labor law also protects residents working outside the country. Brazil enacted legislation during 1982 in response to its companies that have employees rendering services abroad—primarily in the field of construction in countries with different labor legislation—because of concerns that such employees may not enjoy the same labor rights available under Brazilian legislation.

In July 2009, legislators amended the law to extend Brazilian benefits not only to employees of engineering companies working outside Brazil but also to all on foreign assignments regardless of the economic activity of their employers. This amendment extended Brazilian labor rights to employees working outside Brazil—in the event that they would not enjoy equivalent rights in the host countries. However, if a host country grants benefits (e.g., vacation, Christmas bonus) equal to or better than Brazil's, generally an employee would not be entitled to claim such benefits from Brazil.

Taxation

Brazil has a sophisticated, codified personal taxation system that taxes individuals up to a maximum of 27.5% of their income. Understanding the system in order to ensure compliance and maximize tax-planning opportunities is critical for successful assignments to Brazil.

Basic concepts

Similar to most of the developed countries, tax residency and source of income primarily drive the taxation of an individual assigned to Brazil. Tax residents are taxable on worldwide income (unless statutorily exempt), and nonresidents are generally taxable solely on Brazilian-sourced income.

Brazil considers foreign employees as tax residents as of their dates of entrance—under either a permanent visa or a temporary visa type V with a local employment contract. Holders of temporary visa type V without a local employment contract would be considered tax residents of Brazil after 183 days of physical presence in the country, consecutive or not, during any given 12-month period.

Similar to the United States, Brazil allows an individual to claim a foreign tax credit to offset Brazilian income tax imposed on foreign-source income, provided there is either a tax treaty or a reciprocal tax agreement between Brazil and the foreign country. Although there is no income tax treaty between the United States and Brazil, the Brazilian tax authorities have officially confirmed that US federal (but not state) taxes paid to the United States may be claimed as a foreign tax credit, subject to certain limitations. Solely foreign taxes actually paid (i.e., accrual method is not allowed) may be credited.

Income sourcing

Under the tax laws of most countries (including the United States), the source of compensation income for tax purposes typically would be determined based on where services were performed (i.e., the location of the employer, the payroll, and the payer are irrelevant). Brazil, however, determines the source of compensation income by the location of the payer—irrespective of where the work was performed. This relatively unique income-sourcing legislation may offer tax-planning opportunities but may also create pitfalls for the unwary.

In the case of a US citizen deployed and working full-time in Brazil, typically it would be advisable to keep the employee on the US payroll subject to actual US income tax withholding (instead of hypo tax withholding) in order to minimize the possibility of double taxation. Because in Brazil the compensation paid from the United States would be deemed US-sourced income and be subject to US income tax, an individual would claim a foreign tax credit in Brazil for the US tax withheld. This arrangement typically would reduce or eliminate the Brazilian income tax liability and generally ensure that the individual would claim a full foreign tax credit in the United States for any residual Brazilian tax.

However, in the case of a Brazilian employee deployed to the United States, keeping the employee on the Brazilian payroll could result in an onerous double-taxation situation. Such an individual would be deemed to have earned income from US sources under US tax law but also from Brazilian sources for Brazilian tax purposes. Such inconsistent sourcing of income between the United States and Brazil would result in taxing the income in both countries, with basically no foreign tax credit relief. Thus, generally it would be advisable to transfer the employee to the US payroll so as to be paid from the United States.

This tax tips summary should be evaluated in conjunction with other corporate tax ramifications to ensure the avoidance of adverse corporate tax consequences.

Tax compliance

Tax residents of Brazil are required to file income tax returns on a calendar-year basis (January 1 to December 31). Residents must file their returns on or before the last business day of April of the following year, and no filing extensions are allowed. The income tax return must reflect worldwide income net of expenses and deductions allowed, as well as income taxes paid and/or withheld

at source during the year. Taxes are usually deducted directly from employee's salary, but tax payments on other income (e.g., income from outside Brazil) must be made via a monthly filing (called *carne-leão*) with a commercial bank.

Interestingly, the Brazilian income tax return must also include a list of assets and liabilities in the taxpayer's name as of December 31 of the related calendar year (or departure date in the year of breaking residency). All global assets must be reported irrespective of where they are located, including:

- Real estate properties, vehicles, watercrafts, and aircrafts—irrespective of their acquisition values
- Other movable property valued at more than BRL5,000 (\$2,940)
- Bank accounts with balances in excess of BRL140 (\$82)
- Shares, gold, and financial assets of BRL1,000 (\$590) or more

Assets should be reported at cost instead of at market value and may include assets of the spouse and dependents in certain circumstances.

Furthermore, individuals are required to declare their liabilities with banks, credit companies, individuals, loans abroad, etc.

The Brazilian government utilizes this comprehensive asset and liability disclosure to scrutinize whether annual variations in a taxpayer's equity would be in sync with income declared. Also, by capturing information about income-producing assets outside Brazil, the tax authorities become able to identify income from foreign sources. This approach is considerably more comprehensive than that of the US system, in which

assets typically are reported via income tax returns only for calculating depreciation or depletion or for reflecting an asset's cost in the year of sale or disposal. Probably the only US requirement to disclose assets that is somewhat similar to Brazil's is the annual foreign bank account form due on June 30, but that is limited to certain non-US financial accounts.

Brazilian residents who leave the country permanently should file exit procedure returns, which include a Communication of Departure, an Exit income tax return, and a request for a Tax Clearance Certificate to declare themselves as nonresidents on the day of their departure. This releases them from fiscal obligations in Brazil.

Should they not file the exit procedure return, they would become nonresidents only after 12 months of physical absence. Thus, it is generally advisable to formally claim no residency upon departure.

Conclusion

Brazil is the only BRIC in the Americas. Time will tell what international economic position Brazil will gain, but a country with so much potential and momentum can be expected to become a more prominent global player. Therefore, investors should take action now to position themselves for reaping the long-term benefits that such an important market is projected to offer.



Cost-saving opportunities for international assignees in Japan

Nasir Majid and Michael Johnston

In light of the recent economic uncertainty, many companies have taken decisive actions to counterbalance the high costs of maintaining their expatriate assignee populations in Japan. Recent trends include a marked increase in localizations, an increasing number of short-term versus long-term assignments, and, in many cases, repatriation of segments of the existing assignee population. If implemented effectively, these measures can curb the costs associated with maintaining expatriates. However, in the long term, some of these measures might leave companies disadvantaged, weakened by a loss of foreign talent in a highly competitive marketplace once the economy recovers.

In reflecting on assignment cost-cutting measures, companies must ask themselves whether they have implemented their stringent actions in savings procurement effectively and whether other, less drastic cost-saving initiatives were possible and actively explored.

Because high Japanese taxes are often primary factors in cost-containment planning for international assignments, it is essential that companies be aware of the broad range of tax-planning opportunities available and, more important, aware of how they can implement those opportunities effectively without incurring unnecessary incremental risk.

Tax-effective delivery of compensation and benefits

Redesign of incentive compensation

Governments, the general public, and the media have placed tremendous pressure on companies—particularly companies in the financial services industry—to curtail the practice of awarding excessive annual cash bonuses. Some contend that such bonuses reward short-term performance, which may result in increased risk taking. The situation has led to a growing demand for increased alignment of incentive compensation with long-term performance.

A redesign of incentive compensation, which grants an award in one year but requires continued employment until it becomes payable (vests) several years later, is compatible with rewarding long-term performance and can be very tax efficient for temporary assignees in Japan. Companies can achieve significant savings if they defer vesting and payment under a business rationale until after the assignment is completed, thereby resulting in taxation at the current nonresidential national flat tax rate of 20%. Similarly, market value stock options can provide deferral and may enjoy nonresident taxation if exercised after repatriation. In contrast, taxation at the resident rates can be as high as an effective 47.5% for combined national and local taxes.

If companies cannot defer compensation, they may want to consider equity awards. With this option, the assignee can benefit from the lower capital gains tax rate in Japan on the future sale of shares. In the present economic environment, in which share values are generally depressed and far below their historical highs, an outright grant of vested shares or a program that encourages assignees to purchase shares at relatively low or discounted prices can be particularly attractive, because future appreciation would be subject to a 20% combined capital gains tax rate. Furthermore, those gains would not be subject to tax in Japan for assignees who sell their shares of a foreign-based company during the first five years of assignment or after departure. This also assumes that the assignees will neither use a Japanese broker for the sale nor remit the gains from the foreign sale into Japan.

With assignment start date and anticipated end date in mind, companies should regularly review unvested expatriate balances accrued in incentive plans. In many cases, the acceleration of the assignment end date, even by one day, could result in significant tax savings. Of course, the company should also consider the tax implications in the employee's next location to confirm the overall tax effectiveness of this strategy.

Compensation policy review

Reviewing the expatriate compensation policy and benchmarking it against the competition are prudent practices. Companies can often generate savings through localization initiatives, elimination or phased reductions of foreign service premiums, a once-annually home leave policy, review of housing norms, assessment of state hypothetical taxes and relocation entitlements, and so forth. The current economic climate presents a ripe opportunity to ensure that compensation policies are in line with the new marketplace.

Companies generally implement plans that are intended to deliver tax-effective housing, education, and home leave benefits to their assignees in Japan. However, companies leave themselves vulnerable to compliance challenges because they sometimes fail to maintain appropriate written policies or to ensure that application of those policies is adequate to withstand the scrutiny of tax audits.

The audit is a routine part of Japan's tax environment, and in many cases, decisions are rendered on a form-over-substance basis. Recent tax auditor challenges on company-provided housing have highlighted the necessity for policies to be consistent with the tax requirements. Ambiguity in documentation or failure to maintain policy integrity in operation can result in denied tax benefits.

Finally, review of compensation policy should also include the market lease cost of rental housing in Japan. Companies may be able to take advantage of the sharp decline in rental values due to the downturn when renewing employee housing leases or negotiating new ones. In the Tokyo area, for example, we understand that some companies have recently renegotiated leases on top-end housing and realized savings as high as 30%.

International assignee policies — Japan

Japan tax split policy

Many companies have overlooked incorporating Japan-specific addenda (Japan tax split policy) into their broad-based equalization policies. Such addenda are important when addressing the individual tax implications that occur should an expatriate transfer to a local employment package (localize) or terminate employment with the company but remain in Japan.

The absence of such addenda can lead to inconsistent treatment and additional tax costs if policies are determined on an ad hoc basis. With an increasing number of assignees falling into these categories, it has become essential to document a policy that addresses several related factors, including:

- Tax treatment of trailing payments
- Allocation of deductions, exemptions, and credits
- Priority on the benefits of graduated tax rates
- Gross-up rates applicable to final year settlements

In some unfortunate cases, the absence of a policy addressing separation arrangements resulted in the company's bearing the additional Japanese local inhabitant tax costs, which could have been averted with a basic policy document. A company that clearly articulates its obligation and tax responsibility by developing a policy that addresses separation events under multiple scenarios can realize significant savings.

Localization

Localization of expatriates often allows companies to reduce costs while providing the local company in the host country continued benefit from the expatriate's international knowledge and experience. Unfortunately, some expatriates may not be receptive to moving from an assignment compensation package containing "expatriate" benefits and into a local employment package without such benefits (either immediately or by phaseout).

To facilitate localization discussions and to counteract the negative connotations associated with a local package, companies may want to consider their answers to the following questions.

- Does the Japanese company have a retirement plan so the individual can take advantage of the favorable tax treatments afforded to retirement income? (Retirement income is taxed at approximately half the tax rate of employment income.)
- Does the Japanese company provide a housing plan that allows the individual to benefit from the reduced taxation that would offset the high cost of housing in Japan?
- Does the individual understand that a social security tax agreement exists between Japan and the United States and that any years of contributions to the US or Japanese social security system will count toward determining eligibility to receive social security retirement benefits potentially from both countries?

Effective implementation of localization strategies, in certain cases, can provide the company with savings and provide an overall better net cash result for the individual. The bottom-line approach is often the most effective means to stifling negative associations one may hold with respect to localization.

Outbound assignments

Tax equalization covers an increasing number of Japanese nationals sent on outbound assignments. However, in many cases, particularly with smaller companies, written tax equalization policies do not exist, even though the presumption by employer and employee is that tax equalization will be applied. The absence of written policies often results in questions in preparing the tax equalization calculation and in delays in settlements—not to mention the uncertainty and possible dissatisfaction felt by the employee over the results.

A company-specific equalization policy generally improves the assignee's experience regarding tax reimbursements, and it results in a more efficient process, with timely settlements. The tax equalization policy may also address some common tax-planning techniques to minimize overall cost, such as ensuring final gross-up payments are made before reestablishing tax residency in Japan.

Short-term-assignee planning

Short-term assignments can be extremely beneficial to companies—especially from a cost perspective—but they can also be extremely complicated to administer. In most situations, short-term assignments require compliance in at least two tax jurisdictions, are potentially affected by a number of income tax conventions, and require consideration of even stricter immigration laws. In addition to those external issues, companies must ensure they conduct the internal tracking and administration tasks necessary to properly monitor both tax compliance and immigration compliance.

To determine the tax implications related to short-term assignments to Japan, it is critical that companies distinguish whether the assignee is a business traveler or is under a secondment arrangement. Japan follows the most recent commentary from the Organisation for Economic Co-operation and Development's model treaty regarding

tax exemption for compensation (the so-called 183-day rule). OECD commentary prescribes that an individual would be subject to taxation “even if he/she spent less than 183 days in Japan during a 12-month period and would otherwise qualify under an applicable income tax treaty” if it is determined that the individual was seconded to Japan instead of being sent on a business trip.

The difference between a short-term assignee and a business traveler can be open to interpretation, but a general distinction can be made. If a shift in reporting lines occurs and the Japanese entity is deriving the primary benefits of the individual’s service, it would be difficult to substantiate that the employee is in Japan as a business traveler.

However, companies should not view in isolation the loss of treaty exemption in the case of secondments. The corporate tax rate in Japan is about 42%, which is much higher than the corporate tax rate in some other major industrialized countries. Companies might realize greater tax savings where assignment costs can be charged to the benefiting entity in Japan, thereby lowering the overall corporate tax rate. The 20% nonresident tax rate that the individual would be subject to in Japan can often be taken as a foreign tax credit on the tax return in the home country, or an income exemption can be obtained, thus neutralizing the impact of any one individual income tax. Therefore, the secondment alternative could result in overall tax savings in the right circumstances and with proper planning.

Another area of assignment planning that companies often overlook involves the unintended consequences of short-term assignments. Short-term assignments may contribute to a Japanese permanent-establishment risk for the foreign sending company, and unattended immigration matters for frequent travelers could lead to denied entries and lost business opportunities. Because those are just two examples of commonly encountered

areas where potential risk could be associated with short-term assignments, companies should conduct careful evaluation of assignment structuring prior to initiating assignments to Japan.

With careful planning and guidance, companies can navigate through the complex maze of tax, immigration, and administration issues associated with short-term assignments and still achieve the desired cost savings and business objectives.

Totalization and social security tax

Japan currently has 10 in-force social security agreements and a number of countries with agreements under preparation and negotiation. While the intention of the agreements is to encourage temporary worker exchanges, companies will need to remain vigilant and maintain a good understanding of the complexities of the agreements in order to fully benefit—as well as comply.

In addition to the avoidance of double social security taxation between Japan and the other country, most agreements include provisions that allow assignees to remain for a number of years under their home country systems while on assignment and provide a totalization of benefits should assignees ever need to contribute to the host country’s system. This is particularly important, as many assignees are heavily invested in their home country pension plans and may be hesitant to enroll in the Japanese system if it is more costly and/or there is a perceived loss of benefits. Companies will also need to ensure that they periodically review their assignee populations and relevant agreements in force to ensure they obtain proper certificates of coverage (including extensions) and that they adequately evaluate potential savings opportunities.

Under new visa and immigration rules effective from April 2010, applicants may be required to present proof of social insurance coverage to obtain a working visa. (At the time of this writing, the government had not officially confirmed this new requirement.) If applicable, the new rule places renewed emphasis on ensuring that individuals not covered under a totalization agreement obtain appropriate coverage in the Japanese system. In the past, companies with assignees on offshore payrolls often overlooked the requirement of Japanese coverage, because the potential risks associated with noncompliance were low. However, because the risk of noncompliance may now result in denial of a visa to work in Japan, compliance in this area is of critical importance.

Companies may face challenges in creating a system for enrollment if the affected assignees are paid fully through offshore payrolls with no mechanism in place to facilitate payments locally to the Japanese social insurance agency. Potential solutions may include arranging split payrolls through which minimal salary is delivered onshore to settle contributions. Another possible solution may be to enroll the assignees as if they were self-employed. Under the self-employed enrollment method, a company representative or third-party agent may be permitted to enroll groups of such individuals by proxy.

Beyond the administrative challenges of enrolling in the Japanese pension system, companies should be aware of the costs associated with maintaining individuals in the system. For example, combined contributions to Japanese health insurance coverage and pensions are generally lower than contributions to US Federal Insurance Contributions Act (FICA) tax for Social Security and Medicare. As such, companies with US expatriates no longer covered under the totalization agreement due to assignments exceeding five years may actually realize savings by enrolling in the Japanese system.

Japan recently updated its tax law for the amended Japan/France tax treaty effective January 1, 2008. Under the amended tax treaty, a deduction for qualified French social security contributions is available to both residents and nonresidents filing Japanese tax returns. Companies can achieve significant savings because of the high rate of contributions and a marginal Japanese tax rate of 50% for residents. Companies will need to maintain the appropriate documentation necessary to claim deductions for contributions and need to submit required information.

Review of tax accruals for reduction in provisional taxes

A basic exercise companies sometimes overlook is the ensuring that money is not overaccrued for scheduled tax payments. The Japanese tax assessment system requires a prepayment of two-thirds of the estimated current-year national tax liability (based on the prior year's national tax balance) in advance of the filing of a tax return. Whether assignees depart Japan, localize and pay tax through withholdings at source, terminate employment, or have their salaries reduced significantly, companies should carefully examine all scenarios to determine whether filing a tax reduction is possible.

Because income levels have decreased significantly due to the economic environment, filing for reduction of provisional taxes has become a more prevalent practice. For tax-equalized assignees, filing for reduction of assessments frees up money set aside for funding current-year taxes and can result in a reduction in tax-on-tax costs. It also reduces the risk of overpayment and related lengthy delays in obtaining refunds.

Director taxation rules—corporate deductibility

Corporate tax rules effective from fiscal years commencing on or after April 1, 2006, provide corporate tax deductibility for remuneration paid to company directors in amounts of fixed monthly payments, payments in accordance with advance notification at the tax office, and performance bonuses paid in proportion to the company's earnings to directors who engage in the operation of the company's business. Previously, any payment to directors other than an equal number of periodic payments was treated as a bonus and not deductible.

The guidelines set forth for the corporate deductibility of director remuneration are complex, so companies should ensure that proper procedural and legal guidelines are observed to in turn ensure qualification for corporate deductibility of remuneration payments. Companies should also be aware of recent guidance issued by the national tax agency, which provides flexibility for reducing director remuneration payments while maintaining corporate deductibility due to worsening financial conditions.

Summary

Many companies unknowingly operate under the presumption that they have addressed the tax needs of their expatriate populations in Japan via global standardized policies or loosely constructed documents. Although the intent may have been written into those documents, we consistently encounter safeguards inadequate to maintain the tax effectiveness of intended policies specific to Japan. We have illustrated a number of key areas of which companies should maintain awareness in respect to potential cost-saving opportunities such as compensation planning, totalization, localization, and short-term assignments. Companies large and small should actively evaluate current policies and seek guidance for assistance they may require in order to properly review current plans for necessary safeguards and to pursue additional cost-saving initiatives. In light of the economic uncertainty of recent times, companies cannot afford to squander opportunities that can significantly reduce the potential costs of operating in Japan.



Forward foundations: Where will engineering and construction companies explore growth, and what will it mean for talent strategy?

Samir Mammadov and Larry Poss (Fluor Corporation)

In the aftermath of the worst economic crisis since the Great Depression, the engineering and construction (E&C) industry, like much of the business world, must push hard to win new work in an exceptionally competitive marketplace. Clean energy technologies, infrastructure spending, and projects large and small in regional markets across the globe offer some of the most promising opportunities for future growth.

The state of today's markets, although painful in the short term, may present an elegant business solution driven by an emerging workforce demographic trend. More than 90% of E&C leaders responding to a recent PricewaterhouseCoopers survey see international assignments as "important" or "very important" to their future organizational success,¹ a perception that appears to align with the expectations of a key emerging workforce segment, the millennial generation.

This new breed of workers has a global orientation and sees international assignment as a highly valued career development opportunity, which they rank ahead of cash bonuses as an attractive benefit.² But overseas growth and international assignments come with obstacles as varied as the people who fill them and the countries that host them. Is your company up to the challenge?

Leaders weigh in on economy, E&C prognosis

Massive reverberations in the credit and financial markets have shaken economic confidence worldwide, from the C-suite to the consumer on the street. The E&C industry typically lags general market trends, and so, while economic activity remains depressed, major capital expenditures have been deferred and projects are subject to scope reductions or even cancellations.

Eighty-five percent—a 40% increase over the previous year—of E&C chief executive officers surveyed by PricewaterhouseCoopers are concerned that the downturn in major economies would threaten growth.³

Industry CEOs register a sharp drop in confidence since the economic downturn set in: Only 18% say they are "very confident" they would see increased revenue over the next 12 months—a 70% decrease since the prior survey, in which 56% of E&C leaders expressed such optimism. Only 15% say they feel "very confident" about the industry's outlook. More than three-quarters of E&C CEOs expect that global banking system conditions will raise the cost of credit and restrict access to finance; and about two-thirds say they may be forced to delay investment plans and curb their growth expectations.⁴

International opportunities and challenges

Turbulent times require increased emphasis on cost discipline, but not if it means degrading the capabilities that enable an organization to compete effectively for major projects as the global economy recovers. Growth potential has not vanished, but it has shifted—largely to emerging markets, where infrastructure development projects, stronger economies, and rich oil reserves can yield revenue opportunities. However, to realize the benefits, companies must be prepared to untangle a host of complex challenges, many of which have to do with talent management.

Industrial and urban growth in emerging markets has translated into increased consumer demand, government spending, and receptivity toward inbound investors in support of infrastructure development in China, India, Russia, and Central and Eastern Europe, among others.

¹ *International Mobility in the E&C Sector*, PricewaterhouseCoopers, 2008.

² *Managing tomorrow's people: Millennials at work: Perspectives from a new generation*, PricewaterhouseCoopers, 2008.

³ 11th and 12th annual global CEO surveys, PricewaterhouseCoopers, 2008 and 2009.

⁴ 12th Annual Global CEO Survey, PricewaterhouseCoopers, 2009.

E&C leaders should be prepared to manage regulatory challenges, procurement strategies, and the variables inherent in local markets and business cultures, along with complicated talent-related HR demands and compliance complexities such as immigration and social security. As E&C companies pursue work in these newly emerging but unfamiliar markets, they should engage the right consultants in advance in order to be prepared to deal with those regulatory requirements, immigration laws, tax challenges, and cultural issues.

Eighty percent of employers responding to PricewaterhouseCoopers' E&C industry survey cite tax compliance and regulatory compliance as the top two important factors in the management of international assignments. While nearly 60% identify the ability to manage talent efficiently as a top focal point, less than 40% recognize compensation the same way, thereby illustrating a lapse in understanding of the close interrelationship between solid talent management and employee retention, including the role of compensation in addition to the value of nonmonetary rewards from employees' points of view.⁵

Moving people to build business

Building business in the global market means moving people to meet opportunity. Travel—including short-term assignments to deliver new contracts and including long-term commitments to deliver work—is an inescapable reality in today's business environment, and it presents a host of responsibilities. This poses a critical challenge—particularly to such industries as E&C as they broaden their horizons to support growth in turbulent economic times.

An expanding globally mobile workforce raises myriad hurdles and calls for ongoing vigilance on the part of leadership. Leaders who hope to take effective advantage of global opportunities will need to increase their ability to perform proactively and agilely, or they'll risk missing those opportunities for the growth of their organizations and that of their organizations' people.

International assignments can produce a dizzying array of management challenges. The greater the number of assignees and destinations, the murkier the picture and the higher the stakes can become. Clearly, such moves take time and money; they also can result in unforeseen complexities and risks that demand the right responses, with little time for reaction and little margin for error.

In fact, leadership may not recognize these issues until the issues have negatively impacted management and employees. This can be especially difficult for E&C companies, for which the pace of international mobility is accelerating. Accurate expatriate cost projections; reliable information on immigration requirements, labor laws, and local health; and safety and security issues can have critical impacts on being able to deliver projects on time and under budget. Larger E&C companies bear a particular burden in this regard because major projects tend to rely on sizable teams of in-house staff as well as several external contractors and may involve multiple such projects in numerous locations.

Lack of foresight and appropriate strategy can sap international assignment effectiveness by costing employers in unforeseen tax and social security expenditures, heightened revenue authority scrutiny, and frustrated, discontented workers. Among the many matters employers need to expect and plan for are (1) resettling and appropriately compensating and recognizing expatriate employees and their families in new environments and (2) host country taxation, regulation, and social security compliance by employees and employers.

⁵ *International Mobility in the E&C Sector*, PricewaterhouseCoopers, 2008.

Companies that have expatriate populations numbering in the thousands need to plan even more carefully to develop and launch effective policies for managing overseas assignees and international recruits. They should:

- Provide appropriate host country support for international assignees and their families.
- Know how the company will develop, motivate, and retain international assignees on an ongoing basis, including upon their return from host countries.
- Manage the costs associated with international assignments.
- Remain alert to compliance obligations and risks, including immigration, tax, social security, and local employment regulations.

Managing global assignments, balancing books: Might shared services work for your company?⁶

Some companies, caught between cost constraints and the need to manage international growth opportunities, are turning to outsourcing in order to balance conflicting demands. The traditional E&C approach to international assignment typically relies on an in-house team responsible for the range of related work, with a smaller group dedicated to day-to-day expat support, such as coordinating tax equalization (TEQ) with finance, TEQ receivable collections, and international policy. Overarching shared services may include:

- Assignment management of home country employees
- Visa and immigration coordination
- Medical coordination

- Management of household items, shipments, and storage
- Home-sale-and-purchase administration
- Destination service coordination
- Expat tax administration

This model can result in inadequate focus on potential risks due to internal resources constraints and low employee satisfaction ratings in response to policies that are not aligned with retention strategy. Other problems include the slow processing of TEQ payments and collections, the diminished capabilities of capped internal resources, and the difficulty of meeting fluctuating service delivery demands under a fixed-cost model while also controlling overhead costs. At the same time, business unit support can fail to focus on specific units and can lack alignment to project business services and the ability to communicate with sales regarding proposals.

The outsourcing option

The outsourcing model relies on the outsourcing of mobility services to a third party that becomes accountable for the range of transactional activities, including expat support. Such change to using a third party can enable the company to shift its internal resources to more-strategic oversight and governance roles, achieving:

- Faster delivery by matching resources to schedules
- Elimination of overhead and streamlining of reimbursement by sending pass-through billings directly from the outsourcer to the project
- Improved accuracy through the use of industry experts

⁶ Information compiled by PricewaterhouseCoopers and Fluor Corporation.

- Upgraded customer service for employees and business units through enhanced product and process knowledge, project site visits, and on-site support
- Reduced capital expenditures on systems
- Development of a global model of knowledge through the provision of host country experience and resources
- Shift to a variable-cost support model
- Proposal development and project maintenance and closeout support via an assignment cost projection tool or service
- Improved work processes and cost-saving strategies by initiating cross-functional relationships with finance, human resources, project business services, and sales
- Policy administration to support retention while confirming tax policy compliance on a global basis
- Improved response to regulatory changes on a global basis in such areas as immigration, tax, and labor laws

Know international assignment costs, savings, and valued measures

To effectively manage direct and ancillary international assignment expenses, companies should scope those costs in advance. They should have a process for calculating the cost implications of in-house versus external service providers. And they should fully investigate potential tax savings in each host country. At the same time, leadership needs to affirm that double-taxation treaties have been reviewed to identify potential tax liabilities in host countries in which the company may recharge costs.

International assignment policies should be followed consistently throughout the organization, remain flexible enough to respond to market conditions in a variety of countries, and enable the company to dispatch expats to hosts within a time frame that aligns with the business's overall response time for embarking on new market endeavors. To identify business trips that may evolve into international assignments and to be ready to respond appropriately, companies should monitor developments when staff are sent abroad to conduct on-site bids and other business.

To reinforce employee retention among crucial human capital, international assignment policy should include concrete measures for motivation, development, and retention of skilled staff. The company should review extra compensation packages for international assignments in order to assess whether the packages are competitive and whether they accurately reflect the range of living and market conditions abroad. Companies should also systematically track post-international-assignment retention rates and benchmark them against their overall performance on that metric.

A new generation enters the workforce eager to depart for distant shores

PricewaterhouseCoopers' 12th Annual Global CEO Survey suggests that many E&C companies grasp the deep connection between talent management and international mobility, but few have responded with strategies predicated on that underlying synergy. Often, companies fail to align assignment policy with overarching enterprise objectives. Such issues as recruiting, rewarding, and retaining top talent are vital, given economic and demographic indicators and acute skills shortages in the industry.

While dramatic economic challenges predominate—and sometimes preoccupy discussions—among business leaders in the current economic climate, they should not eclipse crucial strategic and operational considerations, especially as E&C companies venture into emerging territory. Cost cutting may be imperative for many companies nowadays, but so too are more-traditional business needs, such as robust consumer relations and adequate, appropriate staffing. The two are closely related, as a thorough, well-rounded approach to recruiting, developing, and retaining the right talent can have direct bearing on a company's performance and brand—critical factors, especially in a down economy.

Overly aggressive cuts to strategically critical programs such as training and international assignments can likewise undermine sustainable growth and quash access to key, potential-laden geographic markets. It may seem a stretch to think about such threats as global labor shortages in these economically challenging times, but the crunch for talent going forward will become a reality as surely as the credit crunch is today.

Even in the midst of the economic slowdown, 48% of E&C executives who responded to the annual survey voice concern that the availability of key skills might adversely affect their companies' growth prospects. And that concern will become only more heightened with time. One needs look no further than baby boomer retirement demographics to see what an aging workforce portends for much of the world in the next decade.

As businesses struggle to recruit and retain key talent and skills in coming years, the millennial generation⁷—for which career development and international work opportunities are expected to be major draws—will gain traction in corporate corridors and on trains, planes, and automobiles. Millennials have already started to emerge in significant numbers: Their workforce representation grew by 18.5% from 2007 to 2008. At the same time,

Generation X employees constituted more than 50% of workers for the first time, according to a recent PricewaterhouseCoopers survey.⁸

Millennials are mobile in their thinking, whether that means access to actual travel or to the technology that enables them to bring their lives along with them in a pocket, on the fly, anytime and anywhere they desire. And they perceive international exposure as a main component in career development. Eighty percent of millennials surveyed by PricewaterhouseCoopers want to work abroad, and 70% anticipate using other languages in the course of their careers.

They may be the first generation for whom the classic mantra, "There's no place like home," does not ring entirely true. So, employers take heed: We're not in Kansas anymore. If those in the workforce of the near future seek career advancement through international assignments, they have arrived at the right place and time.

E&C companies should look closely at their talent management capabilities, with a specific focus on international assignment policies and those policies' implications for remuneration and retention. At a time when skilled talent is scarce and becoming more so, international assignments represent an investment in expertise and a crucial individual and organizational ingredient for successful global operations.

Talent retention: Sending top performers abroad to keep top talent on board

With talent wars looming and substantial knowledge exiting via a large outflows of mature workers, retention of highly valued talent and roles should be a critical component of HR strategy and global assignment determinations. For E&C companies looking to expand the

7 Born from 1980 to 2000; also known as Generation Y.

8 Saratoga 2009/2010 *US Human Capital Effectiveness Report Executive Summary*, PricewaterhouseCoopers, 2009.

borders of their operations, project managers—who will increasingly be drawn from the up and coming millennial generation—will be key players.

Given a project-driven environment, companies are increasingly focusing on identifying and developing local talent and looking to the subsequent placement of this growing pool of high-potential employees in other project locations around the world. This enables companies to provide a better mix of experienced expatriates while remaining competitive, because local nationals in emerging markets tend to be less costly compared with typical developed-market expats sent to other locations.

A systematic approach to talent management with respect to international assignments can be a tremendous ally in a company's bid to reward and retain top performers. Such talent management will be a crucial area in which employers can distinguish themselves in the perceptions of tomorrow's workforce, with 98% of millennials surveyed calling out strong coaching and mentoring as important developmental components.

Leadership should remain mindful that even in a deeply connected virtual world, sometimes there really is no place like home when it comes to crucial employee touch points. For that reason, special care and planning should go into performance reviews for expat workers.

Nearly 80% of E&C leaders surveyed by PricewaterhouseCoopers use the same evaluation systems for expats that they use for the general employee population,⁹ indicating a potential gap in their ability to retain pivotal talent when it becomes an increasingly rare resource. Reviews can play a pivotal role in retention and should continue to be conducted regularly for international assignees and tailored to suit their needs, because they typically lack direct interpersonal access to supervisors, mentors, and other key players in career development. Failures in the performance process can spell trouble when assignees return home, so *out of sight* should certainly not mean *out of mind*.

E&C companies, which tend toward decentralized operations, cannot assume that one model will be adopted by each location; they need to develop programs that can work effectively throughout the enterprise and then to confirm that the programs get implemented consistently enterprise-wide.

Prized repatriated staff in key roles such as project management should return to a receptive home base and appropriate rewards. Despite cost concerns in challenging economic times, companies investing in international assignments and career development will not realize significant gains if they lose returning expats once the jet lag wears off. Management should agree on an effective incentive program based on onetime bonuses, or on share-based incentives, or on cash-based plans.

A classic winning approach to conquering new vistas

As economic conditions bring forth new business realities, E&C companies increasingly seek out fresh opportunities in new and emerging markets. The terrain may vary widely, along with regulatory and compliance demands, but certain imperatives remain decidedly focused and clear: Companies need to adjust to changing times while managing talent issues with the same astute foresight and broad-based view that have always been the chief distinguishing characteristics of sound leadership.

Talent management does not recede into the jet stream as assignees take off for distant lands. If anything, it becomes more important than ever. Labor and skills shortages indicate a growing need for thoughtful and consistent people processes. Remember that tomorrow's top performers will often look to foreign assignments for their own personal growth, even as the company looks ahead and abroad for revenue growth. Companies can find places where those interests can coexist and mutually thrive, but first, it takes a plan that makes sense for the enterprise, its markets, and its people.

⁹ *International Mobility in the E&C Sector*, PricewaterhouseCoopers, 2008.



International assignment costs: The charge-out challenge

Brant Ferrell and Bryan Bishop

As companies address current market conditions and focus on cost containment, one of the areas they sometimes overlook is a review of their current process for allocating international assignment salaries and other costs within the organization. In fact, the development of a systematic approach to the intercompany allocation of international assignment costs can result in benefits to the organization, such as seeing a more equitable distribution of expenses, realizing all corporate tax deductions, and potentially minimizing expatriate tax costs.

Those challenges are not new, but the economic downturn has most likely caused increased scrutiny of previous decisions regarding the costs associated with international assignments. Planning to minimize costs—and to communicate to stakeholders throughout the business the allocation of those costs—may not have been properly executed. As a result, businesses are being forced to balance the strategic priorities of the company's long-term vision with short-term cost-containment initiatives. As companies evaluate the costs and benefits of international assignments, a clear understanding of the principles of an intercompany charge should add clarity to the financial impact an employee has on the organization.

This article will help readers examine the challenges created by the intercompany cost allocation process within an organization, define the key stakeholders who need to be brought to the table, and suggest alternatives that may enable a company to better manage the process.

Understanding the challenges of the charge-out

One of the key elements in successfully resolving the intercompany charge dilemma is to gain an understanding of the challenges presented to the company. The typical challenges companies face regarding intercompany cost allocations are that key stakeholders (1) do not understand the impact of the

employment relationship on the charge, (2) do not understand the basis for determining the charge, (3) do not want to accept the charge, or (4) do not effectively manage the corporate tax deductibility and/or the financial statement impact of the charge.

For the business, the significant additional cost of the cross-border employee may disproportionately impact the local budgets.

- The corporate tax department wants assignment-related costs borne in the country where services are rendered, so that corporate tax deductions are not lost.
- The chief financial officer wants costs allocated in accordance with appropriate accounting standards.
- In order to reduce income reportable to the host country, short-term assignees may not want costs charged to the host country.
- In developing markets, business managers may wish to negotiate a cost-sharing arrangement so as to make the assignment more affordable in the host location.

These differing agendas can often individually drive the ways costs get allocated within an organization—without regard to the overall impact on the organization.

Employment relationship

One factor in the identification of all stakeholders and in the application of the proper process to the charge in a specific circumstance is the determination of the employment relationship. The most common employment relationships are business travelers, permanent transfers with regional responsibilities, short-term assignees (12 months or less), and long-term assignees (more than a year).

Principle of the charge

Key to understanding the proper intercompany cost allocation is the process of determining which business entity should bear the cost of the internationally mobile employee. Such costs are generally borne by the business entity that receives the primary benefit of the employee's services. In the case of long-term assignments with secondment agreements, this is relatively easy to identify because the business entity receiving the primary benefit of the services should be clearly defined within the secondment agreement. In other cases, such as employees with regional responsibilities or on short-term business trips, the determination of which entity should bear the costs and the alternatives available makes the situation much more complex. In those situations, the facts and circumstances need examination to review the alternatives and properly account for the charges.

Financial performance of the business

Companies may encounter resistance from the stakeholders impacted financially by the intercompany charge. Key stakeholders such as local-country business owners or joint venture partners may understand the concept of the intercompany cost allocation process but, due to the significant cost, may be reluctant to accept the charge due to the impact on their budgets. The costs associated with an internationally mobile employee can often be two to three times the costs for a local employee. In the absence of a proper preassignment cost projection and communication to these particular stakeholders, companies face the challenge of overcoming disagreements within the organization due to underestimating the total cost to the bottom line.

Corporate income tax deductions

The company must effectively manage the corporate income tax issues associated with the intercompany cost allocation process. In fact, a company's inability to collaborate with its corporate tax department in regard

to an intercompany charge can create several adverse consequences for the company. In regard to long-term assignments, not charging out the costs to the local entity could result in a lost tax deduction or an incorrect tax deduction. In regard to short-term assignments, business trips, and permanent transfers, not examining the alternatives may lead to an unnecessary value-added tax, additional tax filings in certain foreign jurisdictions due to permanent-establishment issues, blown treaty exclusions, and so on.

Impact of financial statement reporting standards

Accounting standards often contain guidance regarding the reporting of expenses related to the revenue earned by various business ventures. These accounting standards may vary by country or jurisdiction and may include generally accepted accounting principles, International Financial Reporting Standards, and the like.

Impact on individual income tax reporting

In some jurisdictions, individuals on temporary assignments are not taxed locally if their salary and assignment-related costs are not charged to or borne by a permanent establishment in that jurisdiction. As a result, such employees may wish the costs to be borne in *one* location so as to reduce their income tax liability, while the company may wish the costs to be borne in a *different* location so as to claim a corporate tax deduction for the expenses.

As readers can see, in order to tackle the challenges the intercompany charge presents to the organization, it is critical to educate stakeholders and determine overall impact. Getting preemptive buy-in on the process and developing procedures to handle the intercompany charge will offer the greatest opportunity for success with key stakeholders. Failure to do so could result in unexpected financial statement charges, increased tax costs or lost deductions, and internal arguments between business units or joint venture partners.

Identifying the stakeholders

In most cases, a company's human resources, corporate tax, and finance departments—along with the local business managers—should be considered stakeholders in regard to intercompany cost allocation. Depending on the specific circumstance, additional stakeholders such as joint venture partners, payroll departments, and others may need to be considered.

With regard to business travelers and permanent transfers with regional responsibilities, the key issue is typically determination of the responsibilities the employees have in the local jurisdictions. Corporate tax managers, finance managers, internal counsel, and local business managers are therefore critical decision makers in determining the most appropriate allocation of costs. If a charge-out of costs is deemed appropriate and additional individual tax consequences need to be addressed, stakeholders such as representatives of payroll and human resources should probably be present at the table.

In the case of short-term assignments, the key issue is typically determination of the options available to minimize corporate and individual income tax costs in the local jurisdiction. Income tax treaties may allow an individual to avoid establishing tax residency in the foreign location, provided the length of the assignment falls under certain day thresholds and there is no charge-out of the costs to a permanent establishment in the host jurisdiction. However, that treatment could result in a loss of the corporate tax deduction related to those expenses. The tax department and, potentially, internal counsel are, therefore, critical stakeholders for determining whether the benefits of an income tax treaty should be claimed. Other stakeholders may include the finance, payroll, and human resources departments.

In the case of long-term assignments, the key issue is typically coordination of the appropriate assignment documents. The human resources and corporate tax departments are usually key stakeholders in drafting secondment and chargeback agreements as well as

in reviewing assignment cost projections. The payroll department, local business managers, and the finance department are key stakeholders that need to be included for buy-off of the anticipated costs and process. Joint venture partners may also need to be informed in advance of the assignment.

Common alternatives for allocating costs

There are several widely used alternatives for allocating costs within an organization. The most common is a direct charge of all expenses from one corporate entity to another. Such a charge may consist of actual expenses or expenses plus a markup. This method is normally used in the case of a traditional long-term assignment. As previously discussed, the rationale behind this approach is that the entity benefiting from the services and the corresponding entity where the corporate deduction should be allowed are clearly defined within a secondment agreement.

Other methods of allocating costs include a management fee, locally paid expenses, or a hybrid approach. In these instances, the benefiting entity may not be clear, or special consideration has been given to the entity that should bear the cost; and usually tax planning (individual and corporate) needs to be considered.

Under a management fee approach, the employing entity (often the home country organization) bears the cost of the employee and there is a charge to the local entity receiving certain services—in the form of a management fee. The amount of the management fee is typically determined by a formal agreement among participating entities, and many costs (including but not limited to salaries) are considered in the calculation of the fee. This approach requires careful analysis by the corporate tax department, internal counsel, and the finance department because a variety of issues may arise such as transfer pricing regulations, challenges by local tax authorities, and fitting under a company's risk profile. This approach may be the one to take in cases where large project teams are being deployed or where

the local business cannot afford to bear the full cost of an international assignment.

In the case of locally paid expenses, the local entity is responsible for the payment of some or all of the costs of the assignment. In most circumstances, the employing entity bears the basic employment costs—such as salary, bonus, and equity—and the local entity bears the expenses, such as housing, per diems, and automobile costs. This approach is typically used for short-term assignees or frequent business travelers when an income tax treaty is present between the employees' home and host countries and when the benefits of this treaty will be utilized to minimize individual income taxation. The OECD model tax treaty provides exemption from tax in the host jurisdiction for certain short-term business trips/assignments, provided that costs are not charged to the local permanent establishment. Any host-country-paid expenses will be subject to taxation in accordance with host country tax laws and, if excluded from taxation, may be borne by the host company. Companies also utilize local payment and expense in the case of longer-term assignments, as long as they do not jeopardize the employee's home country benefits package.

A hybrid approach is defined as any combination of the aforementioned methods. This approach is typically used in instances of permanent-transfer employees with regional responsibilities. A hybrid approach requires additional administration. It is taken in order to best approximate the most reasonable allocation of costs among the different entities the employees may support.

Impact on business travelers and short-term assignment arrangements

Due to the complexities of corporate and individual income taxation surrounding short-term assignees and business travelers, companies typically consider the following alternatives with regard to the charge-out.

- Employment entity bears all costs, and no intercompany charge to the host entity: Generally conservative and most widely used
- Direct charge of all costs to host entity: Generally conservative but could create additional tax costs and filings for the individual and company
- Locally paid expenses and the employing entity bears the salary cost (treaty situations): Generally conservative approach, provided domestic law excludes these costs from taxation. Collaboration with corporate tax and legal advised
- Management fee approach: Generally aggressive approach that needs to be carefully analyzed with legal and corporate tax departments

Market practice for short-term assignees and business travelers is for the employment entity to bear the costs, with no charge-out of expenses. The rationale behind this approach is that companies either desire to fit under the provisions of income tax treaties or will take the viewpoint that due to the relative short-term nature of these arrangements, this simplistic approach is the best method. The problem with this blanket approach with regard to all short-term assignments is that certain cost-planning approaches (e.g., a locally paid expense and management fee) may not have been considered. The end objective of fitting under a treaty position may still have been available under either of these two approaches with the added benefit of having the host entity bear some of the cost.

Deviation from an employment-entity approach typically occurs in circumstances in which companies have large populations of short-term business travelers and therefore have become familiar—through experience—with the alternatives available. The impact to one entity that employs many short-term business travelers who are providing benefits for other entities can become significant. Therefore, companies favor either the locally paid approach or the management fee approach in an

effort to fit under the applicable treaty as well as have the local entity share some of the assignment costs. In economic downturns, when cash flow is at a premium and companies struggle to make their numbers, a more detailed look into the options available can provide significant benefits for companies.

Impact on long-term-assignment arrangements

The costs associated with long-term assignments are typically managed as follows.

- Direct allocation of costs to the host entity: Most conservative and reasonable approach under these circumstances. A method that ensures correct allocation of the corporate tax deduction
- Employment entity bears the cost: Aggressive if corporate tax deduction is taken by the incorrect entity or if result is a potential lost corporate tax deduction

Market practice under long-term-assignment arrangements is the direct allocation method. The rationale behind this approach is that the entity that benefits from the services is typically clearly defined under the assignment and secondment agreements. Therefore, the company could be forfeiting its right to the corporate income tax deduction if the company does not allocate the expenses to the local entity.

As mentioned earlier, deviating from direct allocation of costs can create adverse consequences for an organization. The main issue that corporations face is either an incorrect corporate tax deduction taken in the employment entity location (which creates audit risk to the organization) or loss of a corporate tax deduction. It needs to be noted that there can be instances when the charge-out to the local entity will create certain withholding taxes or other taxes that exceed the benefit of a corporate tax deduction in the local country. The corporate tax and finance departments generally will determine the cost benefit under these types of circumstances.

Impact of permanent transfers with regional responsibilities

One area where companies struggle to ascertain the proper cost allocation method involves employees with regional responsibilities. Because these employees provide benefits for multiple entities and locations, the proper allocation method must be selected carefully. Some of the common alternatives are:

- Allocation of costs based on time apportionment. This alternative apportions the cost based on the relative amount of time the employee spends working in the different locations. Although this alternative typically matches the individual tax residency rules, it may not accurately depict the corporate impact of the role of those rules within the region.
- Allocation of costs based on sales or margin apportionment. This alternative typically allocates cost based on a factor that more closely aligns the impact of the employee's activities with the particular productivity levels of the countries those activities support.
- Equal allocation of costs among all the entities supported within the region. This alternative allocates costs pro rata over the region the employee supports.
- Employment entity that bears the cost. This is the most simplistic approach and typically the least defensible alternative in cases of individuals with regional responsibilities.

Market practice in this area is typically for the employment entity to bear the cost of the employee. Due to the inherent permanent-establishment concerns with charging costs out to local entities and due to the complexities of defining the appropriate allocation method, companies typically keep the costs in the country of employment. In the event costs get allocated to other territories, the charge-out of costs is supported by detailed documentation of the employee's responsibilities in each country. The employee is also responsible for maintaining appropriate travel records.

Other corporate tax considerations

Other factors that should be considered when addressing the issues of the charge-out are:

Intercompany charge agreements. To defend the charge-out upon audit and to limit any misunderstanding within the company, companies would be wise to consider the use of intercompany charge agreements. These agreements substantiate the nature and reasoning for the charge-out and are agreed to between the applicable entities prior to the assignment.

Corporate withholding taxes. Discussed briefly earlier was the impact of the intercompany charge in the form of corporate withholding taxes. In some countries, the ability to repatriate cash is difficult without the company's absorbing high costs. For instance, the charge-out concept is not widely used by developing countries such as Brazil, and it's difficult for the employment entity to get reimbursed for its costs without incurring the service tax charge. In other countries, such as India, the charge-out may need to be substantiated with certain government forms. Companies will need to be well versed in each country's particular rule regarding this issue in order to maximize the benefits of the charge-out and to avoid delays in reimbursement.

Value-added tax (VAT). VAT is a consumption tax levied on an organization for any value added to a product or service. An organization's decision to allocate costs to a permanent establishment in another jurisdiction due to the duties of an employee's services to that entity's business may create additional VAT to the host jurisdiction. These additional costs need to be evaluated in the determination of the proper allocation amount.

Transfer pricing. A concept correlated to the intercompany charge allocation process is the issue of transfer pricing. It typically comes about when a

management fee approach or other non-direct-cost reimbursement method is chosen. If the management fee is too high, companies risk challenge by the authorities that they are using this methodology for purposes of tax-free repatriation of earnings rather than for a reimbursement of costs in the form of a management fee.

Cash flow. As companies look to find ways to increase cash flow, one area that might be overlooked is the issue of the intercompany charges. Companies may have significant dollars at stake, where, upon adequate substantiation, they can be reimbursed by their overseas entities for the costs of employee support within those jurisdictions.

Summary

The challenges are complex surrounding intercompany charges in relation to internationally mobile employees. Depending on the employment relationship, the organization will have several alternatives to consider when evaluating the most appropriate method. An organization's ability to address these alternatives when developing its intercompany cost allocation process, to identify the key stakeholders who will be affected by the intercompany charge, and to educate the key stakeholders about the underlying principles of the intercompany charge will facilitate a more successful process. Approval processes and requirements should be part of every organization's international assignment governance model. Failure to proactively address the process and/or the impact on key stakeholders can result in unexpected charges and surprises, potential missed tax-planning opportunities, and adverse financial statement consequences.



Code Section 121 tax law changes: Implications for international assignees

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Introduction

For over a decade, we have seen significant changes to Section 121 of the Internal Revenue Code, ranging from the Taxpayer Relief Act of 1997 to the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 and the recent Housing and Economic Recovery Act of 2008 (Housing Act).¹ The objective of the most recent Housing Act was to help make the American dream affordable for families struggling to make ends meet during the current recession, provide assistance to weather the housing foreclosure crisis, and give an impetus to the weakening economy.

Significant provisions are included in the Housing Act that are intended to serve as catalysts for the efforts by Congress to restore normalcy. However, the amendment, which specifically added Code Sec. 121(b)(4)[(5)], may have unintended negative consequences for individuals with temporary absences from their homes.²

This article reviews the recent changes to Code Sec. 121, with particular focus on individuals temporarily absent from their residences while on international assignments.

Code Sec. 121—General provisions

Under Code Sec. 121, a taxpayer who sells a principal residence can generally exclude gain of up to \$250,000 (\$500,000 for married couples filing jointly), provided the property has been “owned” and “used” by the taxpayer as the taxpayer’s principal residence for two of the past five years ending on the date of sale. For married couples, either spouse can meet the ownership test, but each spouse must meet the use test. If one of the spouses does not meet the use test, the exclusion of gain would apply to each spouse individually as though they were not married.

The exclusion can be used only once every two years. Further, it does not apply to the portion of gain attributable to depreciation claimed on any business use of the property; the recapture of this depreciation is taxed at 25% under Code Sec. 1250.

Under Reg. §1.121-3, taxpayers who fail to meet the two-of-five-year-ownership-and-use requirement because of a change in place of employment, health, or unforeseen circumstances are entitled to a ratable portion of the exclusion. The allowable exclusion is determined by using a ratio of actual months owned and used over 24 months. Whether the requirements of this section are satisfied depends on all the facts and circumstances.

Under the regulations, a sale or exchange is necessitated by change in place of employment if it occurs during the period of the taxpayer’s ownership and use of the property as a principal residence and if the new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment. (This is a safe harbor; other circumstances may also qualify as a change in place of employment.) An “unforeseen circumstance” is the occurrence of an event that could not have reasonably been anticipated before purchasing and occupying the residence.

Amendment to Code Sec. 121

Code Sec. 121(b)(4)[(5)] was enacted as part of the Housing Assistance Tax Act of 2008 and was expected to generate \$1.4 billion in revenue. The basic rules under Code Sec. 121 were not altered by the addition of Code Sec. 121(b)(4)[(5)]. The exclusion mounts, qualifying test, and reduced exclusion rules and qualifications remain intact.

Code Sec. 121(b)(4)[(5)] adds the concept of nonqualified use. If a taxpayer has a period of nonqualified use, the portion of gain related to such period cannot be excluded and is taxed as a capital gain.

¹ P.L. 110-289.

² Act Sec. 3092(a) of the Housing Assistance Tax Act of 2008 (P.L. 110-289).

Nonqualified use is any period after December 31, 2008, that the taxpayer does not occupy a residence as a principal residence. Exceptions to this general rule are as follows.

- Any period of temporary absence, not to exceed two years, due to change in place of employment, health conditions, or unforeseen circumstances (as may be specified by the secretary) is not treated as nonqualified use.
- During the five-year qualification period ending on the date of sale, any period after the last day such property is used as a principal residence is not treated as nonqualified use.
- Any period, not to exceed an aggregate of 10 years, during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty is not treated as nonqualified use.

Congressional intent

A common practice, until the recent amendment, was to take advantage of the benefits of the Code Sec. 121 exclusion by converting an appreciated vacation home or rental property to a principal residence, meet the two-year occupancy requirement, and thereby qualify the property for gain exclusion. In addition, because the benefits of Code Sec. 121 were available once every two years, a taxpayer could repeat this pattern and continuously reap the benefits of Code Sec. 121.

Recognizing this unintended consequence, Congress included provisions in the Housing Assistance Tax Act that would tax any portion of gain related to nonqualified use. The projected \$1.4 billion in revenue expected to be raised under Code Sec. 121(b)(4)[(5)] was intended to offset some of the revenue losses resulting from incentives provided under the Economic Recovery Act of 2008.³

Consequences of Code Sec. 121

Although the enactment of Code Sec. 121(b)(4)[(5)] effectively targets investment-driven residential real estate purchases and sales, it can have significant consequences for taxpayers who vacate their principal residences while temporarily away on international assignments.

As noted earlier, the law contains a favorable exception to nonqualified use that allows for temporary absences of up to two years and a further exception for periods of use following use by the taxpayer as a principal residence. However, if a taxpayer is absent for more than two years and reoccupies the residence upon return, the entire period of absence may be treated as nonqualified use (to the extent the absence occurs after 2008).

The following examples illustrate this issue.

Example 1. John purchased a vacation home for \$200,000 on January 1, 2008, but moved into it and began using it as his principal residence on January 1, 2009. He moved out of the house on December 31, 2010, and sold the house on December 31, 2011, for \$300,000.

John meets the ownership-and-use test, having owned and used the home as a principal residence for two of the five years prior to sale. He has *no period of nonqualified use, as any use prior to January 1, 2009, is not counted toward nonqualified use*. Further, the one-year period after December 31, 2010, is not treated as nonqualified use because it is within the five-year period ending on the date of sale and follows the *last* date on which the property was used as a principal residence. Therefore, the entire gain of \$100,000 is excluded under Code Sec. 121.

³ P.L. 110-289.

Example 2. Mary purchased a house on January 1, 2009, for \$200,000 and lived in it as her principal residence until December 31, 2013. Mary is sent by her employer on a foreign assignment for three years and rents out the property during her assignment. She repatriates on January 1, 2017, and reoccupies the house as her principal residence. Mary lives in the house for two years and sells the house on January 1, 2019, for \$500,000.

Mary meets the general ownership-and-use requirements. However, she has three years of nonqualified use from January 1, 2014, through December 31, 2016, since this period exceeds the two-year temporary-absence exception and does not follow a period the property was *last used as a principal residence*. Her total period of ownership is 10 years. The taxable gain is \$90,000, arrived at by multiplying the total gain by the ratio of nonqualified use over the period of ownership of the property: $\$300,000 \times 3/10 = \$90,000$. The remainder is eligible to be exempt from income.

Planning opportunities

While the changes to Code Sec. 121 closed a loophole for property owners who intended to convert their investment properties to principal residences and utilize the exclusion, the opportunity to convert and still retain substantial tax benefits remains. This is due primarily to timing, because a rental period prior to January 1, 2009, is not classified as nonqualified use but is included in the denominator of the calculation (the total period of ownership) in arriving at the taxable gain attributable to nonqualified use.

The following example illustrates this concept.

Example 3. Bill has owned a house since January 1, 2005, that has substantially appreciated in value. Though he originally rented out the house, he moves into it on

January 1, 2010, and occupies it for two years as his principal residence. He then rents out the house for three years and sells it on December 31, 2014. He realizes a \$350,000 gain upon sale, of which \$100,000 is subject to depreciation recapture.

Although Bill has owned the property for 10 years and occupied it as a principal residence for only two years, his taxable capital gain related to nonqualified use is only \$25,000, representing 10% of his gain after depreciation recapture.

Bill has only one year of nonqualified use, from January 1 to December 31, 2009. The rental period prior to January 1, 2009, does not constitute nonqualified use. Additionally, the three-year rental period from January 1, 2012, to December 31, 2014, occurs after the last date that the property was used as a principal residence (but within the five-year period ending on the date of sale) and as such does not count as nonqualified use. Therefore, only one of the 10 years of ownership constitutes nonqualified use.

Impact of Code Sec. 121 on international assignees

Employers with international assignment programs generally take a hands-off approach with respect to an assignee's principal residence. That is, the decision to retain (and potentially rent) the home while on assignment or to sell it is left up to the assignee. Most employers are reluctant to provide home sale assistance, particularly given current economic conditions.

With the recent downturn in the housing market, Code Sec. 121 may not be relevant to many assignees, as the sales of their homes would result in losses. However, given the considerable appreciation in housing prices in many parts of the country over the past 10 years, many taxpayers are still in a gain position. Further, any gains

rolled over under Code Sec. 1034, the predecessor to Code Sec. 121, reduced the basis of the next home purchased. This would increase the gain to be considered under Code Sec. 121 rules. In short, regardless of the current state of the housing market, individuals may have gains on the sales of their principal residences and therefore must be aware of the requirements of Code Sec. 121.

Assignees repatriating prior to January 1, 2011

Generally, a typical international assignment is for three to five years. Given that, many assignees will not meet the two-year temporary-absence exception under the regulations. However, only absences after January 1, 2009, count for the purposes of applying this two-year exception. Therefore, even though individuals may have been absent from their homes for periods in excess of two years, if they repatriate prior to January 1, 2011 — provided all other requirements under Code Sec. 121 have been met—they will meet the temporary-absence exception, with none of their absence constituting nonqualified use.

Repatriating to a new work location

As mentioned, in addition to the two-year temporary-absence exception cited earlier, Code Sec. 121(b)(4)[(5)] also exempts from nonqualified use any period on or after January 1, 2009, that follows the last period during which a property was used as a principal residence.

Employees often lease their former principal residences while on temporary international assignments. If the sale of a former residence takes place after an employee's absence of more than three years, the employee could still qualify for a partial exclusion, since the failure to

meet the two-of-five-year-ownership-and-use test is due to change in place of employment as specified in Reg. §1.121-3. An international assignment generally has been accepted as an unforeseen circumstance as contemplated under these regulations.

The opportunity therefore exists—as it did prior to the passage of Code Sec. 121(b)(4)[(5)]—for an individual to qualify for a partial exclusion if the two-of-five-year test has not been met. The exception under Code Sec. 121(b)(4)[(5)], exempting from nonqualified use any period that follows the last use as a principal residence, is consistent with the favorable treatment allowed under Code Sec. 121 for individuals failing to meet the ownership-and-use tests because of a change in place of employment, health, or unforeseen circumstances. Therefore, as long as the international assignee does not reoccupy the home prior to sale, a full or partial exclusion may be claimed.

Employer policy considerations

It is common practice for employers to tax-equalize employees on international assignments. The intent of employer equalization policies generally is to protect employees from excess tax costs resulting from compensation items related to their assignments.

One common question is whether any taxable gain on the sale of a principal residence caused by nonqualified use during the assignment period should be reimbursed to the employee under the employer's tax equalization policy. Such nonqualified use could occur, as mentioned earlier, if the assignee is absent from the home for a period that exceeds the two-year temporary-absence exception and if the assignee then reoccupies the home upon return.

Many international compensation policies contain provisions that address tax issues related to the sale of a principal residence. When Code Sec. 121 was passed in 1997, replacing Code Sec. 1034's rollover provisions, the potential for an employee on international assignment to incur a tax on the sale of a principal residence increased. By leasing the home during the assignment and remaining on assignment for more than three years, the employee faced the possibility of a reduced exclusion—or potentially no exclusion at all if there was no period of occupancy during the five years prior to sale.

However, under these rules, the maximum amount of the exclusion was reduced if the two-of-five-year test was not met. Accordingly, if the employee's gain was less than the reduced exclusion amount, there was no impact on the employee. Further, the employee could "cure" any shortfall in occupancy by reoccupying the home upon repatriation for a sufficient period of time to meet the two-of-five-year test prior to selling the home and thereby qualify for the maximum exclusion. This is no longer the case under Code Sec. 121(b)(4)[(5)].

Rather than resulting in a reduced exclusion, with the potential for the taxpayer to make up any shortfall in the period of occupancy, a portion of the taxpayer's gain is now treated as taxable to the extent of any period of nonqualified use. Under Code Sec. 121(b)(4)[(5)], the taxpayer will incur a taxable gain if there is a period of nonqualified use during the period of ownership of the property. Further, a period of nonqualified use will exist if the taxpayer is absent for more than two years (with the exception of those who repatriate prior to January 1, 2011, as noted earlier).

Many employer policies have not yet addressed the implications of Code Sec. 121(b)(4)[(5)]. And many employees, particularly those who were on international assignment prior to the passage of Code Sec. 121(b)(4)[(5)], have not been educated as to the impact of the new rules.

Recommendations to address that are as follows.

- Communicate to employees the implications of the changes in law and how those changes may affect them upon sale of their residences. The communication should also clearly outline the employer policy, specifically addressing the amount of tax, if any, that would be reimbursed in the event the employee incurs a taxable gain related to nonqualified use.
- Update international-assignment policies to clearly address the impact of Code Sec. 121. Given the emotion that is often attached to issues around home sales, consideration may be given to adopting a de minimis threshold for reimbursing tax.

For example, assume that an employee has a \$50,000 gain from a home that had been owned for 10 years and there were 3 years of nonqualified use. The taxable gain would be \$15,000 (30% of \$50,000), and the related federal tax and state tax would likely be about \$3,000. Total cost, with gross up, would be approximately \$4,000 to \$5,000. The goodwill created by a de minimis reimbursement, thereby avoiding the protracted discussions and emotion that often attend this issue, may be money well spent by the employer.

Conclusion

The primary purpose of Code Sec. 121(b)(4)[(5)] was to address an unintended benefit available to individuals who converted investment properties to personal use in order to qualify for the benefits of Code Sec. 121. However, the rules may also have consequences for individuals who vacate their principal residences but intend to return to them in the future. The rules contain provisions to help mitigate the impact, but these provisions are narrow in scope and they limit absences to two years (one of the exceptions) to avoid any they tax impact under Code Sec. 121.

Employees on international assignments are particularly affected, as they often retain their homes and may be absent for a period in excess of two years before returning to the houses. Under this fact pattern, if their homes are ultimately sold at a gain, a portion of the gain may not be excluded and will be taxable. Employees in such situations should be made aware of the changes in these rules, and employer policies should be updated to address the employer's involvement, if any, under its international-assignment policy.



2009 Global legislative updates affecting internationally mobile individuals

Philip Miller, Amy Dieffenbacher, and John Parker

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Please note that this article was written to provide an overview of important tax law changes in 2009, many of which take effect in the current year. It is of course important to realize that the global tax landscape is ever evolving, and it is evolving quickly in 2010. To this end, we continue to provide global tax updates through our periodic International Assignment Alerts, and we invite readers to visit www.pwc.com/us/ias for additional information on recent developments.

This year, countries have continued building upon many of the global tax law and immigration law changes that came about during 2008 with respect to internationally mobile employees and their employers. Many of the changes we saw in 2009 not only raise the questions, What income should we tax? and, How should we tax it? but also, Whom should we tax? Perennial issues surrounding the mobility of human capital—such as which job seekers should be allowed to enter a country, how long a particular individual should be permitted to stay, and how the individual should be taxed while there—have been given fresh impetus as governments both new and incumbent reconsider their budgets and their sources of tax revenue. This article highlights some of the significant global tax and immigration updates brought about in 2009 that are related to internationally mobile individuals.

Asia

Australia

With a budget deficit of 32.1 billion Australian dollars that had been forecast for 2008–09 in comparison with the previous year's surplus of \$A19.7 billion and unemployment predicted to reach 8.5% by 2010–11, the Australian treasurer had to balance the aftereffects of the financial crisis and the subsequent stimulus measures enacted against promises made to working families during the 2007 federal election. While the government works on a major overhaul of the tax system—which includes a globally competitive company tax rate high on the agenda—the comprehensive 2009 budget, presented in May 2009, targeted high-income earners through the withdrawal of benefits and the targeting of tax-planning strategies.

Although the treasurer announced no changes to the tax cuts enacted into law after the previous federal election, the tax rate reductions for high-income earners were to be offset by reduced superannuation contribution limits and the means testing of the private health insurance rebate.

Private health insurance offset: A 30% offset is currently available for a percentage of the premium paid to a registered insurer for a complying private health insurance policy. The offset is not currently means tested, but that, too, is expected to change effective July 1, 2010.

At the same time, the Medicare levy surcharge (currently 1% of taxable income and reportable fringe benefits) will increase under a carrot-and-stick approach in order to encourage high-income earners to keep their private health insurance coverage. Low- and middle-income earners who fall below the income thresholds will be unaffected. At the same time, the government introduced a cap on Medicare benefits for a range of items with so-called excessive fees.

Superannuation: The treasurer announced changes that halve tax-deductible-contribution limits for superannuation from \$A50,000 to \$A25,000 effective July 1, 2009, for employers and the self-employed, citing the Australia's Future Tax System Report, which called for a more equitable distribution of tax-assisted voluntary contributions and which questioned the current cap. The new cap will be indexed.

A transitional, unindexed cap for concessional contributions to superannuation for individuals aged 50 or over was reduced—from \$A100,000 to \$A50,000—for the 2009–10, 2010–11, and 2011–12 income years, after which affected persons will revert to the lower, \$A25,000 cap. The limit on nonconcessional (i.e., after-tax) contributions remains at \$A150,000 for the 2009–10 financial year and will increase only when the new, lower, \$A25,000 cap gets increased by indexation.

Finally, the government also reduced the superannuation contribution matching rate for employers.

Overseas earnings exemption: Australian residents working overseas for over 90 consecutive days have historically been eligible for a general exemption of foreign earnings, which was provided to relieve double taxation. The current government is now of the opinion that Australians working in lower-tax jurisdictions are benefiting from an exemption that was intended only to ameliorate the burden of excessive taxes.

The government proposed an amended exemption effective July 1, 2009, that would apply only (1) to income earned as a charitable worker employed by a government agency or by a recognized nongovernmental organization or (2) to income earned as a government worker deployed overseas. Other workers would be provided with offsets against foreign taxes paid on income earned overseas, and the government promised consultations with affected parties to examine the impact of the changes on overseas assignments. Legislation has been passed, and employers are now subject to a highly complex pay-as-you-go and fringe-benefits-tax regime for short-term workers offshore, which will increase the cost of employment significantly.

Employee-share-scheme taxation: In his 2009 budget speech, Australia's treasurer announced new measures to remove the inconsistency between the two types of employee share schemes (ESSs): qualifying and nonqualifying. As a result, all shares and options acquired after 7:30 p.m. on May 12, 2009, were to be taxed at the time of grant. Also, a \$A1,000 up-front concession would be limited to employees with taxable annual incomes of less than \$A60,000 after adjustments for fringe benefits, salary sacrifice, and negative gearing losses.

Prior to the budget there had been two ways for an employee in a qualifying share scheme to have tax on the discount assessed. The employee could elect to be assessed in the income year the shares or options were

acquired and access an up-front tax exemption of up to \$A1,000 on discounts received each year. If an election was not made, taxation of the discount was deferred until a specified later time, such as when the employee disposes of the shares. In comparison, if the shares or options were issued under a nonqualifying scheme, the employee was taxed on the discount when the shares or options were acquired. The employee did not enjoy the tax benefits associated with qualifying employee share schemes.

Reaction to the budget proposal was strong. Given the community concerns and the possible unintended adverse impacts on ESS arrangements for ordinary employees, the government announced on May 24, 2009, that it would be fast-tracking the consultation process—beginning with the release of a policy options paper—seeking to balance industry concerns with the need to address the acknowledged problems of tax evasion and tax avoidance.

A final framework for ESS taxation was released on July 1, 2009. Under the final framework, the taxation of discounts on shares and rights acquired under an ESS would remain the starting principle of the regime.

The main changes are as follows.

- Maximum deferral is reduced from 10 years to 7 years.
- Salary sacrifice deferred share plans are now capped at \$A5,000 of shares.
- Income test for the \$A1,000 up-front tax exemption has increased from \$A60,000 to \$A180,000.

- Removal of the tax-up-front choice: Tax deferral will be accessible only when there is a real risk of forfeiture.
- Deferral schemes will be taxed when there is no longer a risk of losing the share or right and there are no restrictions. Further clarity has been provided on the meaning of *real risk of forfeiture*.
- Reporting requirements apply when share or right is taxed. The full reporting regime will significantly boost the integrity of share plan taxation.
- There will be retention of the taxing point on cessation of employment.

Grappling with the reform of the taxation of employee share schemes since May, by September 2009 the Treasury released (1) draft legislation to implement the proposed changes and (2) draft Application and Transitional Rules for consultation. Under the transition proposals, employee share schemes granted to June 30, 2009, would continue to be subject to the old rules, and shares granted from and including July 1, 2009, were expected to be subject to the new rules.

For foreign employers, this adds another layer of both complexity and administrative difficulty in complying with Australian taxation laws—for both foreign nationals employed in Australia and tax-equalized international assignees seconded (lent) to work in Australia. All employers must now review their share plans and seek advice regarding both employer obligations and the change in tax positions of employees who have a relevant Australian employment. A bill was introduced into Parliament on October 21, 2009, in substantially the same form as the earlier draft. The final Sitting of Parliament was November 16–26, 2009, and the ESS proposals remain open to lobbying.

China

Permanent-establishment issues: As multinational organizations expand their businesses in Asia, international-assignment arrangements have become more prevalent to meet skills shortages and rapid growth. Under a typical arrangement, a foreign multinational second its employees to work in, for example, China for its Chinese affiliate for an expected period of time. Generally, the Chinese entity would reimburse the home entity for the full costs of assignees' salaries, bonuses, allowances, and benefits that the host entity agrees to absorb during the course of the assignments (typically with no profit markup). The arrangement is typically documented by an intercompany supply-of-services arrangement concluded between the relevant entities.

For more than a decade, the Chinese taxing authorities have generally accepted that a home entity seconding employees to a Chinese entity is a mere salary-paying agent and that it is not providing services for the host entity by virtue of the employees assigned to China. The result has been that the home entity is not deemed to have created a permanent establishment in China, although assignees are still subject to tax in China with respect to the incomes related to their assignments there.

However, where assignees are seen as representing the home entity by concluding contracts on its behalf or by engaging in certain activities, the home entity may be deemed as having a permanent establishment in China, with a concomitant exposure to Chinese corporate income tax and, possibly, also China's business tax, which is imposed on provision of services.

In the second half of 2009, the Chinese local-level tax bureaus (LLTBs) began review of assignment arrangements with a view to filling tax revenue gaps. The presumption is that some multinationals are using secondment arrangements to avoid Chinese taxes on service projects undertaken by foreign home entities for host entities in China.

The LLTBs believe—to the extent that salary payments are paid by the home entity to the offshore assignees and subsequently recharged to the host entity in China—that (1) the home entity should be regarded as providing services for the host entity, (2) the reimbursement should be regarded as a service fee payment, and (3) the home entity should be regarded as having a taxable permanent establishment in China—in some cases without regard to tax treaties in place between China and the jurisdiction in which the home entity is based.

A State Administration of Taxation (SAT) circular issued in July 2009—Guoshuifa [2009] No. 114, aimed at highlighting tightened tax administration measures in general—echoes actions being taken at the local level and has placed responsibility for examining international-assignment arrangements with the LLTBs.

Concerns were expressed to the SAT about the stance taken by LLTBs in certain situations, and evidently, the SAT subsequently issued an internal notice asking LLTBs to delay challenges and limit their activities to fact gathering until clearer guidelines can be issued.

The SAT seems inclined to take a more sophisticated approach in assessing the permanent-establishment implications arising from international-employee secondment arrangements and is considering issuing a policy circular to give LLTBs more-specific guidelines in examining secondment arrangements.

It's clear, though, that to avoid unnecessary exposure, multinational organizations and their Chinese affiliates should review their current secondment arrangements, paying close attention to documentation and the information furnished to LLTBs.

Taxation of certain share schemes: In 2009, for the first time, the Chinese Ministry of Finance and the State Administration of Taxation jointly released Circular 5, addressing People's Republic of China (PRC) individual income tax (IIT) treatment of share appreciation rights (SARs) and restricted stock (RS) granted to employees by listed companies. Later in 2009, the SAT issued Circular 461 to provide further clarifications.

Circular 461 now makes it clear that SARs settled in cash are subject to taxation at the time the rights are exercised. The circular also clarifies that RS is subject to taxation at the time the shares become fully vested. RS' taxation requirements are similar to the current taxation requirements of share option plans, explained in Circular 35. PRC-listed companies are required to register their SAR and RS plans with the in-charge PRC local tax authorities in the location(s) where the plans are implemented, and PRC-listed companies are responsible for PRC IIT reporting and withholding requirements with respect to SAR and RS income.

The PRC IIT payable on SARs and RS income is calculated separately from monthly salary tax. This represents preferential tax treatment, because in the absence of Circular 5, the income would be added to monthly salary at the top marginal tax rates, thereby increasing the PRC IIT payable. However, all equity income received in the same tax year would be taxed on a combined basis, which in essence reduces the tax savings potential that the preferential IIT treatment could have achieved had it been applied separately. The circular is silent on the treatment of other common equity plans, and it's possible that other types of rewards may follow the same respective treatment as restricted stock units, SARs, and share option plans. The exact treatment would most likely be uncovered during the registration process.

Circular 461 applies preferential IIT treatment only to listed companies both domestic and overseas, with their equity plans registered with the LLTBs. There is some inconsistency in circulars regarding the imposition of the tax registration process on companies listed in China and companies listed overseas; and this is currently being clarified with the SAT. It is understood that equity-based awards are regarded as an effective means of motivating and retaining talent, and it is believed that there may be increasing use of similar performance-linked, long-term, equity-based awards to replace traditional cash-based incentive compensation for companies to stay competitive, especially in the current economic downturn. While this is evident in the preferential tax treatments clarified in Circulars 5 and 461, the LLTBs are tightening up on enforcement of the tax registration requirements on share option plans and have refused to accept Circular 35 preferential IIT treatment unless the share plan has been properly registered with them, and it stands to reason that the LLTBs will also refuse the Circulars 5 and 461 preferential treatments unless plans are registered properly.

India

The 2009 Finance Act contained some significant changes to the tax regime. In addition, the much-awaited new draft Direct Tax Code has been released for public opinion. Also, significant changes occurred in the country's residency and immigration rules.

Removal of fringe benefit tax and taxation of employee stock plan benefits as perquisites: Effective April 1, 2009, employers no longer have to pay fringe benefit tax (FBT) on fringe benefits provided for employees. The abolition of the FBT restores the old rule of taxing fringe benefits and stock plans via employees. As a result, employers have not had to pay FBT on employee stock plan benefits effective April 1, 2009, as these are now taxable in the hands of employees. Employers have to withhold the tax from the benefit. One of the significant implications of this proposal, for expatriates, is that the tax paid in

India becomes the individual's own tax and may now be eligible for claiming foreign tax credit in the home country. This is subject to the regulations of the expatriate's home country.

The stock plan proposal is likely to be tax neutral because what used to be paid by the employer and recovered from the employee is now paid by the employee directly. From a planning point of view, it is essential that employers review their stock plans for compliance and arrange for a smooth transition from the FBT to accommodate the new tax rule. Further, appropriate measures would have to be taken to deal with FBT already recovered from employers for the period post-April 1, 2009. For other fringe benefits, one has to wait and see regarding any new rules to be prescribed by the government.

Proposed changes in residency rules in the new draft Direct Tax Code: Major changes to tax residency rules were proposed, to take effect from April 1, 2011.

Individuals who meet certain criteria based on their presence in India over a number of years have previously been able to claim Resident but Not Ordinarily Resident (RNOR) status. RNOR individuals are taxed only on income that is received in India, that accrues or is deemed to accrue in India, or that accrues abroad if it arises from a business controlled in or set up in India.

The proposals would eliminate RNOR status. Individuals would be considered resident and therefore taxable on their worldwide income as soon as they exceed a 182-day threshold, under which individuals are considered nonresident. Some relief will still be available to individuals who were considered nonresident prior to this change, in that income from sources outside India will be exempt from tax for the first two financial years under resident status. Under the previous rule, RNOR filers could avail themselves of a similar exclusion for a period of three to four years.

Further proposals would include income accruing in or received outside India in the calculation of total income irrespective of whether the income was subject to tax outside India or whether any other reliefs were available under double-tax agreements entered into by India.

Change in visa requirements: The Indian government also issued new guidance on visa requirements for foreign nationals employed on projects and contracts in India.

Foreign nationals currently employed on projects and contracts in India will now be required to have employment visas. Individuals employed on projects and contracts and working in India on business visas needed to have left the country as their visas expire or by October 31, 2009, whichever was earlier, and obtain employment visas in their countries of origin. Indian missions overseas have been directed not to issue business visas to individuals employed on projects, and current applications are to be returned.

The recently issued guidance states that business visas are to be issued only to foreign businesspeople who wish to visit India for bona fide business purposes, such as to establish or explore the possibility of establishing business ventures in India or to purchase or sell industrial products in India.

Employment visas will be issued only in an individual's country of origin and to qualified professionals or to individuals appointed by Indian organizations to managerial positions or positions involving technical expertise. The authorities say requests will not be considered for either (1) positions where there are a large number of qualified Indian nationals or (2) administrative positions.

Taken together, the changes to the residency rules and the clarifications on the use of business visas may have significant implications for those on inbound assignments to India. Assignees in India on short-term visits may require employment visas. Further, the issue of a visa—whether business or employment—may be subject to greater scrutiny. Organizations with populations of non-Indian employees working in India should review their programs and costing calculations—and, in particular, their short-term-assignment policies—to ensure compliance with visa requirements and to understand and identify the individual and corporate tax and social security implications of the proposed changes.

Japan

Changes in immigration laws: The Japanese government enacted revised immigration laws in the middle of 2009. The laws not only introduced new benefits for foreign residents of Japan but also impose strict penalties for offenders. The new laws are expected to be enforced with greater vigor than has previously been the case.

As of April 2010, regional immigration bureaus began requesting information on individual income tax compliance and Japanese social insurance coverage at the time of applications for visa extensions or at the time of a change in residence status. Local employment insurance authorities began requesting lists of foreign national employees from employers.

Some of the major changes related to foreign residents living and working in Japan as a result of the revised immigration laws are as follows: (1) the maximum period of stay for those whose immigration status already allows them to remain in Japan for longer than three months will be extended from three years to five; (2) a reentry permit will be required only if a foreign resident travels away from Japan for a period exceeding one year; and (3) a new residence card will also be introduced, containing antiforgery features in addition to the information that is shown on the current alien registration card.

As noted earlier, the revised laws also contain additional penalties, which include revocation of resident status, deportation, and imprisonment. Fines levied against both the individual and the employer could be imposed for failure to report changes in status, changes of address, or changes in marital status; fraudulent applications; forgeries; and the encouragement of illegal employment.

While the timing and further details on implementation of the revised laws will be announced over the next three years, it is important for both employers and employees to ensure they are compliant.

Europe

European Union

Social security regulations: New European regulations effective May 1, 2010, will see E101 certificates being replaced by an electronic system of attestations and will allow individuals who get posted from one European Union (EU) member state to another to remain under their home social security plan (provided they are not replacing another worker) for a period not exceeding 24 months, which is double the current 12-month limit.

Other significant changes will impact workers who have duties in two or more EU member states, and the special rules for transport workers have been abolished. The changes are subject to transitional arrangements.

Germany

German state pension reimbursement: Under certain circumstances—due to new social security totalization agreements Germany recently concluded with other countries and due to other changes within the European Union—international assignees may now be permitted to apply for reimbursement of their social security contributions to the German state pension plan, provided they have left Germany.

International assignees actively employed in Germany often had the same obligation to contribute to the German state pension plan as local employees had. However, they may now apply for reimbursement of their contributions if:

- They are no longer obliged to be insured in the German pension plan.
- They are not eligible for voluntary insurance in the German pension plan.
- Two years have elapsed since they left Germany.

There are some limitations to the reimbursement plan. In many cases, citizens of other countries working in Germany may not be eligible for reimbursement if they've paid contributions for more than 60 months. Citizens of the US, Australia, Canada, and South Korea fall into that category. Japanese citizens are not eligible for a reimbursement if they habitually reside in Japan and have paid contributions in Germany for more than 60 months. Citizens of the European Economic Area and Switzerland are not eligible if they habitually reside within this region.

Ireland

Employment permit restrictions: As a result of rising unemployment, further restrictions on eligibility for employment permits were introduced. However, it is expected that the Irish green card scheme will remain in place to attract highly skilled workers to Ireland from outside the European Economic area (EEA).

A green card employment permit allows an individual to work in Ireland for a specific employer and in a specific occupation in which resource shortages exist. The current green card plan is limited to (1) jobs whose basic salaries are at least 60,000 euros per year and whose employment contracts are for a minimum of two years and (2) a limited number of occupations whose salaries range from €30,000 to €60,000 per year. In

response to changes in skills shortages, the list of eligible occupations has been scaled back on a number of occasions since the introduction of the scheme. Most recently, certain roles within the financial services sector, a range of occupations in the healthcare sector, and all marketing roles where the salary is less than €60,000 became designated as ineligible for green cards as a result of a deemed oversupply of labor from within the European Union.

A tougher, labor-market needs test for all work permit applications, including renewals, was implemented June 1, 2009, such that a job vacancy must now be advertised for twice the amount of time previously required. Relaxation of the normal work permit rules that had covered spouses and dependents of employment permit holders has also been curtailed, and spouses/dependents of work permit holders will now have to meet the new work permit criteria in their own individual rights. Spouses/dependents of green card holders are still eligible to apply for a spousal/dependent work permit. In addition, while the government processing fee for a new employment permit has not changed, increased fees apply to renewal work permit applications wherein the individual's first work permit was issued after June 1, 2009. The stricter conditions outlined previously do not apply to an individual who already held a valid work permit prior to June 1, 2009, and who seeks to renew the work permit after that date.

Transitional measures related to Bulgarian and Romanian nationals have been extended until the end of 2011, when the position will be reviewed further.

In addition to increased renewal work permit processing fees, a fee of €500 was introduced for a non-EEA national granted long-term residency from September 7, 2009. However, while 2009 saw the implementation of further restrictions on eligibility for employment permit applications, there has been an increase in the amount of time an employment permit holder who has been made redundant can remain in Ireland to seek alternative

employment. This has increased from three to six months. Furthermore, an individual who has held a work permit for a period of at least five years is entitled to apply for permission to remain in Ireland for a further, 12-month period, which may be renewed further—and without the requirement to hold a further work permit. This replaces the previous unlimited work permit.

New assignment relief program: The new, favorable expatriate tax regime came into effect in January 2009. The program is aimed at attracting key talent from overseas and applies to certain qualifying individuals who come to Ireland to work for a period of at least three years. The relief takes the form of a repayment of taxes collected at source, provided certain conditions are met. A key feature and limitation of the relief is that assignees must be employed by a company that is incorporated and is resident in a country or jurisdiction that is not a party to the EEA agreement but with which Ireland has a double-tax treaty.

Changes in residency rules: Changes to the residence rules have been effective since January 1, 2009. In counting the number of days for tax residence purposes, an individual must now include any day during which the individual is present in the state at any time during that day. Previously, a day was counted only if an individual was present at the end of the day: via the midnight test.

Introduction of income levy: A new income levy became effective in January 2009. The rate at which the income levy was applied was then doubled, along with the existing health levy, with effect from May 2009. The income levy rates that apply to employment income are 2%, 4%, and 6%; and the health levy rates are 4% and 5%, based on specific income thresholds. The top tax rate remains unchanged, at 41%.

Commission on Taxation report: The commission's report was published in September 2009 and includes a number of significant recommendations. These include (1) extension of social security charges to all forms of

share-based remuneration, (2) abolition of the ceiling on employee social security contributions, (3) supplementing the existing 183/280-day tax residence tests with a permanent-home and center-of-vital-interests test, and (4) introduction of fundamental changes in the manner in which tax relief would be allowed for employee pension contributions.

While the commission's recommendations are not binding, those that are likely to generate additional revenue for the Exchequer (minister of finance) are likely to receive early consideration, and some could yet become effective in 2010.

Italy

Amnesty program: The Italian tax system reintroduced for the third time since 2001 a tax shield to allow the repatriation and regularization of offshore capital and assets held by Italian resident individuals. The tax shield can be applied to capital and assets held abroad as of December 31, 2008.

In particular, the amnesty applies to individuals who have held and/or exported capital and assets offshore in violation of tax and administrative provisions, as in the violation to disclose income from said assets on tax returns. The tax amnesty can be applied using both or either of two techniques:

- To regularize and repatriate offshore assets to Italy and/or
- To regularize and hold offshore assets and capital without physical transfer to Italy

Regularize means to declare the investments held abroad and pay only a substitutive tax on income produced in the past. Decree no. 78 established that assets from non-European Union countries must be repatriated to Italy and cannot be regularized.

Amnesty requires payment of 5% of the assets regularized and the filing of a special confidential tax return for disclosure of the assets to be regularized. The requirements must have been fulfilled in the period September 15, 2009, to December 15, 2009.

The amnesty program will protect individuals against any tax and social security audit, and it extinguishes tax penalties, social security penalties, and criminal penalties on offshore assets. Amnesty allows (1) the avoidance of taxation of income produced up to 2008 on offshore assets—as indicated in the confidential tax return—through the payment of a so-called extraordinary tax and (2) the avoidance of filing an Italian tax return for the same assets for the tax period 2009.

United Kingdom

Budget for 2009: New top rate of tax and other changes: The 2009 budget of the United Kingdom, delivered by the Chancellor of the Exchequer in April, contained a number of measures with significant implications for internationally mobile workers and their employers.

The big news was the introduction of a new top income tax rate of 50% effective April 6, 2010, on income above 150,000 pounds per year, which will have a considerable impact on gross-up costs for employers: for every £1 delivered in net benefits/income (a common practice with respect to expatriate employees), it will cost the employer at least £1 in tax for those hitting the new 50% band.

Further, from April 2010 the personal allowance available to each taxpayer (nil tax rate band) is reduced by £1 for every £2 that an individual's income exceeds £100,000, phasing out completely for incomes in excess of £112,950. This may have less impact on internationally mobile employees, as many will have already given up personal allowances to claim the remittance basis.

Any benefit available through the use of a lease premium arrangement became negated by the introduction of new rules effective April 22, 2009, that tax the accommodation provided for assignees by means of a lease premium as if the premium is actual rent paid.

The changes announced in the budget mean that any reliefs that exclude income from UK tax become even more valuable and relevant given other changes as follows.

Changes in residency tax status: The UK tax authority released draft guidance stating that the maximum period of resident/not-ordinarily-resident (R/NOR) status that an individual who remains in the UK for at least three years may claim should end on the April 5 before the third anniversary of the individual's arrival, which is a year earlier than was previously the case.

Broadly speaking, R/NOR individuals may be taxed only on their non-UK-sourced employment income to the extent that it is remitted to the UK (known as overseas workday relief). Previously, individuals coming to the UK with the intention of being present for less than three years could continue to claim NOR status until the beginning of the tax year following the third anniversary of their arrival in the UK, if no firm decision to remain for the longer term had been made.

The changes to overseas workday relief should affect only assignees who originally intended to spend less than three years in the UK but whose assignments will either overrun or get extended. However, employers should check that costing calculations take into account a change of tax status backdated to the start of the tax year; and assignees who will reach in 2009/10 the third anniversary of their arrival should review their individual facts and circumstances to check that those individual facts and circumstances support the continued use of resident/not-ordinarily-resident status. For those who are affected by the changes, the loss of up to a year

of overseas workday relief may add up to a significant additional tax cost.

Mixed-fund rules: One of the aspects of the UK's Finance Act 2008 that affects remittance basis taxpayers was the introduction of extremely complex rules for artificially determining what is remitted to the UK from a mixed fund, which is an overseas account containing more than one type of income or gains or containing income or gains from more than one UK tax year.

In response to stakeholders' concerns, Her Majesty's Revenue & Customs (HMRC) announced a relaxation in the rules for 2008/09 UK tax returns and later provided—for NOR taxpayers—certain clarifications for subsequent years. Note that for resident and ordinarily resident taxpayers, no relaxation has been provided.

To establish which types of funds are being used, the proposed new rules would have effectively required taxpayers to undertake—in advance of every transaction—an analysis of what is contained in their bank accounts. Accounts containing only UK earnings and foreign earnings would have been considered mixed funds under these proposed rules and would have affected NOR taxpayers eligible for overseas workday relief.

Following concerns expressed by stakeholders, for the 2008/09 UK tax year only, HMRC agreed that by concession it will continue to allow R/NOR taxpayers to compare the earnings remitted to the UK with their UK-based general earnings on an annualized basis, so that only remittances in excess of UK-based earnings will be considered taxable remittances of foreign earnings.

For the 2009/10 and subsequent UK tax years, HMRC issued a Statement of Practice that allows employees to treat bank accounts that are held in their sole names and that are composed predominantly of employment income as being outside the mixed-fund law in certain

circumstances, which again means that taxpayers can consider remittances from such accounts on an annualized basis rather than on a transaction-by-transaction basis. The account in question must be held solely by the employee, and it can contain only employment income from a single employment plus:

- Interest arising only on that account
- Gains arising from foreign exchange transactions with respect to the funds in that account
- Gains and certain proceeds arising on employee-share-scheme—related transactions

Jointly held accounts, accounts holding the earnings of more than one person, or income from more than one employment cannot therefore benefit from this exception.

The Statement of Practice continued HMRC's long-standing practices of (1) allowing apportionment of all earnings for a particular tax year between UK and overseas workdays by reference to the workdays in that year as a whole and (2) accepting that earnings for UK workdays are remitted before earnings for non-UK workdays. It is expected to be enacted into law in a new finance act to come, allowing time for further consultation.

Taken together, the increases in tax rates necessitate both greater attention to assignment length and more care in preassignment planning, so as to ensure that assignees' banking arrangements are set up to enable them to benefit from the reliefs that are available.

Pension contribution tax relief: In the budget, the government also announced its intention to limit UK tax relief available to high earners on pension contributions. Assignees into the UK may be claiming UK tax relief for contributions to non-UK (e.g., home-country) pension arrangements and thus may be impacted by these rule changes.

Effective April 6, 2011, the rules apply to taxpayers with total annual incomes of at least £150,000, as they will receive reduced-tax relief only on their contributions. For those earning above £180,000 annually, tax relief will be available only at basic rates. The detailed measures have yet to be published. However, in the meantime, an antiforeshalling provision has been introduced that imposes a special annual allowance charge in certain circumstances on pension contributions made on or after April 22, 2009. The charge limits the tax relief on contributions by clawing back 20% (currently) of the relief in the following circumstances.

- The taxpayer is a member of a UK-registered pension scheme or certain types of non-UK pension schemes for which UK tax relief is claimed.
- The taxpayer's relevant income in the tax year or in either of the two preceding tax years is at least £150,000.
- Total pension contributions (both employee's and employer's) exceed £20,000 or whatever higher amount is identified as regular contributions under the prebudget-day (April 22, 2009) rule.

There are detailed rules in this area—including rules for those making infrequent (i.e., less-than-quarterly) contributions—that permit a maximum special annual allowance of £30,000. An individual can be liable for a special annual allowance charge regardless of resident or domicile status.

Thus, for some assignees to the UK who retain membership in home-country or non-UK pension plans and who obtain UK tax relief for contributions to such plans, this rule change may lead to increased UK tax liabilities, which, if grossed up, may result in an unexpected additional cost to employers. Again, attention is required from employers to identify whether existing or future assignees will trigger this tax charge.

Americas

Mexico

In the last quarter of 2009, the Mexican government's executive branch presented to Congress its proposed revenue package, which will have significant implications if passed.

Changes in overall tax rates: Under the proposals, the highest marginal regular income tax rate (for corporations and individuals) would temporarily increase from 28% to 30% for three years (2010, 2011, and 2012), would decrease to 29% in the fourth year (2013), and, finally, would fall back to 28% in 2014.

Rules providing partial exemption of gains earned on the sale of a personal tax residence would be modified to ensure that the benefit is received only for property used as a personal tax residence, and an individual's deductions claimed for home mortgage interest would be subject to more limitations.

The proposals also provide for a new, 2% tax on sales—similar to a value-added tax and creditable by businesses—to provide funds to help reduce poverty. The new tax would have few exemptions, such as export sales. The effect would be to increase the total consumption tax rate to 17%.

Puerto Rico

Voluntary disclosure program: Because the Puerto Rican Treasury wishes to encourage more taxpayers to disclose their financial information, it has created a program whereby taxpayers may avoid certain negative consequences by voluntarily disclosing information previously not disclosed to the Treasury. The program is not a tax amnesty; any tax liability must be paid in full, and interest charges will not be waived. But the program allows that (1) penalties may be waived at the discretion of the Treasury, (2) taxpayers who voluntarily disclose will

not be prosecuted criminally if certain conditions are met, (3) reporting of delinquent accounts to credit bureaus can be avoided, and (4) further late fees and collection fees can be avoided.

The taxpayer can participate in the voluntary disclosure program only once, and the voluntary disclosure must meet the requirements for timely, sincere, and complete; must originate from legal activities; and must include full payment as defined by the Treasury.

United States

Voluntary disclosure program, too! US taxpayers with unreported income related to offshore transactions could participate in the Internal Revenue Service's (IRS's) voluntary disclosure process and had an October 15, 2009, deadline for a special voluntary disclosure. US taxpayers who reported and paid tax on their income related to offshore transactions but did not file Form 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), could file any delinquent FBAR reports and attach a statement explaining why the reports were filed late. The IRS extended the filing due date for 2008 and previous years' FBAR forms until October 15, 2009.

FBAR reporting has been required to be filed by a US person if the individual has interests in, or signature authority over, foreign financial accounts that exceed in aggregate \$10,000 at any time during the calendar year, but the IRS recently revised the form and instructions.

1. The term *US person* was expanded to mean any person in or doing business in the US.
2. The term *financial account* was clarified to include mutual funds as well as debit and prepaid credit cards.
3. The reporting of the maximum value of the account was changed from selecting predefined ranges to that of reporting an actual dollar amount.

Those changes increased both (1) the administrative burden of completing the form, and (2) the number of filers via its broadened provisions. The October 15 amnesty deadline included FBAR filings for the period 2003–08 and was not available to taxpayers who have already been contacted by the IRS regarding this issue. The amnesty program also applied to certain other information-reporting requirements, such as Forms 3520 and 5471.

Certain taxpayers who had signature authority, but no financial interest, in foreign accounts were also provided a June 30, 2010, deadline for 2008 reporting.

In June 2009, the IRS said it was temporarily suspending the filing requirement for persons who were not US citizens or residents. In addition, the IRS is interested in receiving comments on several of the issues that directly affect an individual's FBAR filing obligation. After the October 15 deadline, the IRS intends to enforce penalties for FBAR noncompliance, which extend from a minimum of \$10,000 for nonwillful noncompliance to as high as \$500,000 and as much as 10 years' imprisonment.

Conclusion

Governments around the world have been articulating changed priorities in response to the global financial crisis. The regular cycle of budgets and finance bills and the processes of policy making begin to deal with the longer-term changes now required to raise revenue, close loopholes, and streamline tax systems in an ever-more-interconnected environment. For multinational companies with globally mobile workforces, the challenge will now be to understand how changes to income tax law, Social Security law, and immigration law will change company costs and affect the ways companies pay their assignees—in addition to the challenges inherent in the ever-present burdens of accurate reporting and compliance.

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