

US shadow payroll for international employees

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In brief

One of the most complex areas that US employers are currently grappling with is international assignee payroll. Both US citizens working abroad (expatriate employees) as well as foreign nationals performing services in the US (inbound employees) can often experience incorrect taxation of their payroll in either the US or the foreign jurisdiction. In light of increased scrutiny by taxing authorities for compliance, employers should have certain processes and procedures in place in order to properly administer the payroll reporting and taxation of expatriate and inbound employees.

Of particular interest is the concept of a 'shadow payroll,' in which a foreign national working in the US is paid by his or her home country but the employer remains responsible for US payroll tax requirements.

We discuss below some of the complexities employers face regarding US employees working abroad and foreign nationals working in the US, along with ideas to ease the compliance burden.

In detail

US employees working in a foreign country

US citizens and US resident aliens are subject to US taxation on their worldwide income regardless of where the individual resides or where services are performed. When services are performed in a foreign country, US tax and employer withholding and reporting requirements for such expatriate employees can prove to be quite complex. From an employer withholding perspective, expatriates are subject to federal, state and local income tax withholding as well as social security and

Medicare taxes unless certain exemptions apply.

For US federal income tax withholding purposes, taxation is dependent on whether the employee is protected under a treaty with the foreign country or qualifies for certain federal income tax exemptions or credits. For state and local taxation purposes, treaty protection and foreign tax credits depend on the employee's state of residence. For example, New York follows the federal treaty rules for state income tax purposes but California does not.

Foreign social taxes (similar to US social security taxes) may be

required unless the employee provides the employer with a Certificate of Coverage under a Social Security Agreement (i.e., totalization agreement), which enables the employee to remain on the US social security and Medicare tax system.

Many employers have global mobility departments and third-party administrators with developed processes to assist with the complex area of expatriate tax return preparation. However, even in these instances, an organization may not have a robust process or support in place for the payroll department. Due to the complex nature of

compensation and compensation delivery for international employees, employers may experience challenges ensuring that their US payroll processes are compliant with federal and state laws.

Foreign nationals working in the US

Tax authorities are paying increased attention to foreign employees performing services in the US. Properly administering the US tax withholding and reporting obligations of international assignees can be quite challenging.

Generally, foreign employees working in the US are subject to federal, state, and local income tax withholding absent any tax treaties. Additionally, employees are subject to US social security and Medicare taxes unless the employer obtains a Certificate of Coverage under a totalization agreement. Also, certain visa holders may be exempt from US taxes.

Host country or home country payroll

An employer must determine whether an employee will be paid on their 'home' or 'host' country's payroll. Home country payroll means an employee will continue to be paid out of the payroll from his or her originating country while host country payroll means an employee will be paid in the country where assigned. There are also split payrolls in which employees may be paid in both countries.

If an international assignee is paid by a foreign country payroll and is subject to US taxation, the employer can utilize a 'shadow payroll' to administer and remain compliant with the US wages and applicable tax withholding and reporting requirements in addition to producing

a US Federal Form W-2. Shadow payroll is a process or mechanism by which the US wage withholding and tax is reported for payroll processed overseas. The use of a shadow payroll may allow the employer to lessen compliance risks if the inbound employee has no payroll withholding and remits his or her taxes at the time the annual US tax return is filed.

Challenges of US payroll processing for foreign employers

For foreign employers, the prospect of complying with US payroll and employment tax requirements can be burdensome especially for a company with limited US operations. In some instances, the absence of a US payroll entity may require a foreign entity to establish a new US subsidiary (or repurpose an existing entity) because a US federal employer identification number ('FEIN') is required to report US employment taxes. It may be difficult for a foreign employer to determine which US taxes are applicable (including state and local employment taxes), how much withholding is required, and the proper reporting and filing requirements for each jurisdiction, many of which require electronic filings. There could also be challenges in paying taxes in US dollars and complying with US deposit requirements, which in certain instances require US withheld taxes to be deposited on the next business day. Further complicating matters, foreign employee compensation is generally 'grossed up' in order to cover the applicable US taxes.

Audit risk from improper taxation

Over the past few years, there has been a renewed focus by the IRS and state taxing authorities on the proper taxation and reporting of foreign nationals performing services in the US. Many employers are often non-

compliant with both payroll withholding and reporting and, in some instances, the inbound employee has failed to file a personal return. As such, the IRS has renewed its focus on this issue and is beginning to more heavily scrutinize the payroll reporting of these individuals.

From a state audit perspective, taxing authorities will review the state and local income tax withholding of foreign nationals to make certain it is based on where the employees live and/or work in the US, including those foreign nationals that may perform services in multiple states.

The takeaway

Effectively complying with two country's payroll tax requirements is a challenge for employers.

PwC's Payroll/Employment Tax Practice can assist employers in implementing a shadow payroll for inbound assignees subject to US reporting and taxation. This includes flexibility in timing and submission of payroll, conversion of foreign currency, along with the accurate computation of the applicable US federal, state and local taxes, and preparation of gross-up calculations.

To further assist employers, our services also include preparing payroll tax deposit coupons; preparing federal, state and local payroll tax filings; and furnishing W-2 forms. Since these issues can be more complex than a regular US payroll, our teams are also integrated with PwC's International Assignee Services practice so that we can provide the full suite of services needed to determine proper taxation from an employer withholding as well as individual income tax perspective.

Let's talk

If you have any questions or would like to discuss further, please contact one of the following individuals.

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