Tax Treatment of Employer-Provided Fringe Benefits for International Assignees

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The Internal Revenue Service (IRS) recently clarified its position on two fringe benefits provided to employees on global assignments: tax equalization services and tax return preparation services. Memorandum Number 201810007 from the IRS's Office of Chief Counsel (OCC), released on March 9, 2018, concerned a large American company employing thousands of employees globally.

This taxpayer and the OCC agreed that tax equalization services were nontaxable fringe benefits and that the tax preparation services received were taxable benefits. However, there was disagreement over how to value tax preparation services, as the returns are often complex and such services are not typically paid for by individual taxpayers but rather through sizeable agreements that reflect economies of scale. The IRS chief counsel's memo provided guidance on how to ascertain the fair market value of the services provided to employees by large multinational accounting firms.

A myriad of fringe benefits are offered to employees by employers during international assignments. Though some benefits are offered to enhance the compensation of today's global workforce, others are offered to ensure that employees are not detrimentally impacted from a financial perspective due to their assignments. Other benefits are offered to ensure that individual employees' minimum legal requirements in the home and host locations are satisfied. Two such fringe benefits are

- tax equalization services, which seek to ensure that an employee's tax burden due to an assignment is "equal" to what it would have been absent the global assignment; and
- tax preparation services, which seek to ensure that an individual's tax return filing obligations are satisfied in both the home and host locations.

The IRS chief counsel's memo addressed the following issues:

1. Whether the value of tax equalization services is included in employee income
2. Whether the value of tax preparation services is included in employee income
3. Whether such taxable benefits are subject to income tax withholding
4. Whether such taxable benefits are subject to Federal Insurance Contributions Act (FICA) tax withholding
5. How taxable benefits are valued
It should be noted that the main focus of this article is on the United States tax consequences of fringe benefits received as part of an employee's global assignment—particularly the treatment and valuation of tax preparation services. However, employers should also be aware that there may be tax obligations in the non-United States jurisdiction.

**Tax Equalization and Tax Preparation Process**

The goal of a tax equalization process is to place a global assignee in the same financial position from a tax perspective that he or she would have been in had the global assignment not occurred. That is to say, the assignee should be neither better off nor worse off due to the global assignment. In order to ensure such parity, a series of calculations are required at different times during the life cycle of a global assignment.

The first step requires the calculation of an approximate hypothetical tax at the beginning of a global assignment based on the assignee’s home country tax obligations. This calculation approximates the anticipated taxes an assignee would face in his or her home country absent the assignment. This baseline calculation is then used to reduce the agreed-upon remuneration of the assignee. That is to say, the take-home or net pay of the employee is adjusted to account for the taxes that he or she would have paid if he or she worked exclusively from the home jurisdiction.

Meanwhile, on a per-pay-period basis for the duration of the assignment, the employer pays actual taxes in home and host locations according to local laws and regulations. This results in additional income being imputed to the employee. To ensure that the additional imputed income does not result in the employee facing additional outlays for income taxes on his or her personal income tax return, such amounts are subject to a gross-up, which results in the employer paying taxes on the taxes paid on the employee’s behalf. If done correctly, the tax impact to the employee is neutral, neither benefiting nor harming the employee’s finances.

At the end of the tax year, the hypothetical tax is recalculated based on actual compensation data and personal income tax details. The actual tax is then subtracted from the approximate hypothetical tax that was calculated at the beginning of the year. If the result is positive, the employer will pay the difference to the employee because the net compensation paid over the course of the year was understated. If the result is negative, the employee will pay the employer because the net pay was overstated over the course of the year. This settlement payment results in the employee being “equalized” from a tax perspective—that is, neither better off nor worse off because of the global assignment. Rather, the net pay impact from taxes is the same as if the employee had not been stationed away from home.

Separately, tax returns for assignees are prepared according to local requirements in the home and host locations, accounting for local differences in compensation definitions and the timing of recognition. This service is beneficial to global assignees, particularly in host locations where there may be language barriers and a lack of connections to local tax return preparers. Tax return preparation services often include services to address inquiries from taxing authorities relating to positions taken on personal tax returns.

Though the provision of tax equalization services and tax preparation services to employees on international assignments is undeniably beneficial, the question remains whether the value of such services is includable in employee income and subject to wage withholding and reporting.
“Gross income” is broadly defined by the Internal Revenue Code (IRC) to include “all income from whatever sources derived,” including fringe benefits. Thus, absent a statutory exclusion, any fringe benefit provided to an employee by an employer is considered gross income.

One such statutory exclusion applies to “working condition” fringe benefits, defined as “any property or services provided to an employee of [an] employer to the extent that, if the employee paid for such property or services, [the] payment would be allowable as a deduction under [Code] section 162 or 167.” In order to be excludable as a working condition fringe benefit, the employer must derive a substantial business benefit from the provision of the property or services that is distinct from the benefit that it would derive from the mere payment of additional compensation.

**Tax Preparation**

The IRS chief counsel’s memo found that the provision of tax preparation services confers a direct and personal benefit on the employee, rather than a benefit to the employer. That is to say, an employer does not receive a sufficient benefit from ensuring that an employee completes a tax return for the provision of such services to be considered ordinary and necessary business expenses. The IRS chief counsel’s memo concluded that personal income tax preparation expenses are not excludable as a working condition fringe benefit because they are not IRC Section 162 expenses.

Tax preparation costs still may be deductible under IRC Section 212, which applies to expenses incurred for the determination, collection, or refund of any tax. However, IRC Section 212 expenses are not eligible for exclusion from an employee’s income as a working condition fringe benefit.

**Tax Equalization**

On the other hand, the IRS chief counsel’s memo stated that any additional benefit provided to the assignees in connection with the tax equalization process was primarily provided for the employer’s benefit and was therefore excludable from the assignees’ incomes. Employers receive significant benefits from sending employees on global assignments (such as gaining access to new markets, among other advantages). Tax equalization is a tool used by employers to ensure that employees are willing to take global assignments by removing concerns over adverse tax consequences from an employee’s decision-making process.

Therefore, the IRS chief counsel’s memo concluded that tax equalization services paid for by employers are excludable from employees’ income as working condition fringe benefits.

**Federal Income Tax Withholding**

Every employer is generally required to deduct and withhold federal income tax from wages. “Wages” are broadly defined to include all remuneration for services performed by an employee for his or her employer, including cash and benefits paid in any medium other than cash. However, wages do not include amounts that are reasonably believed to be excluded as a working condition fringe benefit;
reasonably believed to be excluded as foreign earned income under IRC Section 911; or
paid for services performed outside of the United States and subject to mandatory foreign income tax withholding.

The result of these provisions is that amounts paid by an employer for tax return preparation services for an assignee are subject to United States federal income tax withholding.

IRC Section 911 provides for the exclusion of foreign earned income and housing costs for qualified individuals, subject to an exclusion cap. For this provision, a qualified individual is one with a tax home outside the United States who is either (1) a United States citizen that is a resident of a different country for a full year or (2) a citizen or resident present in a different country for at least 330 days in any 12-month period. The exclusion cap is pro-rated on a daily basis based on the earning period for amounts received from sources within a foreign country, subject to an annual limit. The annual limit adjusts for cost-of-living factors, with the 2018 limit being $104,100.

**Federal Insurance Contributions Act Withholding**

Every employer paying wages is required to withhold and pay FICA taxes. The IRC broadly defines “wages” for FICA purposes to include all remuneration for employment, including both cash and benefits paid in a medium other than cash. However, one exception from the wages definition exists for benefits provided if there is a reasonable belief that the employee will be able to exclude such benefits as a working condition fringe benefit (among several other inapplicable exceptions). Though “employment” generally is defined to include all service performed by an employee within the United States, the term also includes services performed by a United States citizen outside the United States for an American employer, which is essentially an entity organized or residing in the United States.

Thus, unless an amount is reasonably believed to be excludable as a working condition fringe benefit, a United States citizen working outside of the United States for an American employer will be subject to FICA withholding on nonexcludable fringe benefits. This includes costs associated with tax return preparation services paid for by an employer.

An additional caveat worth mentioning relates to “totalization agreements” that the United States has entered into with many countries for the purpose of avoiding double taxation of income with respect to social taxes. Totalization agreements provide that employees are subject to social taxes in the countries where the work is performed. Under the “detached worker” exception, employees who work in a host country for a temporary period are subject to social taxes only in their home countries. A “temporary period” is typically defined as one that is not expected to exceed five years. In the event that an employee is sent to work in a different country for more than five years, the employee would be subject to the social taxes in the host country.

Totalization agreements should be considered prior to the start of an assignment to ensure the opportunity to engineer and structure an assignment in an optimal design.

**Determining the Value of Tax Preparation Services**
In determining how much income to impute to its assignee, the taxpayer in the IRS chief counsel's memo based its valuation of the tax return preparation services on a survey conducted by the National Society of Accountants regarding average tax preparation fees, and a U.S. Department of the Treasury notice that estimated the average time burden and average cost of preparing a tax return.

However, the IRS disagreed with that valuation methodology and instead asked for details regarding the actual fees paid to the employer's service provider, a large multinational accounting firm. The position taken by the IRS in the chief counsel's memo is that the fair market value of the tax preparation services is the amount that an individual would have to pay for such services in an arm's length transaction.

Though the employer's cost is generally not determinative of the fair market value because it may be lower than the amount an individual would have to pay for a benefit due to bulk purchasing and economies of scale, in this instance the IRS did focus on the actual fees paid by the employer. Based on this case's facts and circumstances—including the fact that individuals generally do not contract directly with large multinational accounting firms—the IRS found that in this instance the employer's cost was the best indicator of the fair market value of the benefits received.

**Conclusion**

On these two common fringe benefits—tax equalization services and tax preparation services—the IRS chief counsel's memo provides welcome guidance, albeit in a form that may not be cited or used as precedent. With the increased prevalence of global assignments, assignees' heightened awareness of the plethora of available benefits, and taxing authorities' sophisticated means of identifying the tax obligations of assignees, proactive and enhanced global tax compliance is recommended. As employers contemplate how such global tax compliance will impact operational budgets, consideration should be given to the tax treatment of fringe benefits offered through global mobility programs.

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