

Global HR Hot Topic

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Expatriates, US Tax Withholding, US Social Security Contributions—and COBRA



Challenge:
US tax withholding, social security and COBRA medical insurance continuation mandates can reach US expatriates working abroad, significantly complicating payroll.

Employer income tax withholding, social security contributions and employee benefits mandates usually amount to a straightforward issue of the local law at the place of employment. An employee working in Italy is subject to Italian tax withholding, social security and benefits mandates. Someone based in Chile is subject to corresponding Chilean rules. Staff in Korea is subject to Korea’s requirements.

This means that an inbound expatriate whose place of employment shifts to a new host country generally gets caught under host country tax withholding, social security and benefits requirements. This is certainly how it works stateside: A foreign entity—one not organized under US law—that employs an alien who immigrates to the US and works a job in, say, Seattle or St. Louis is almost always subject to US tax withholding requirements, to US social security contributions and to US COBRA medical insurance continuation. Cf. IRS Rev.Rul. 92-106 (12/7/92). The US does not want foreign employers to use their offshore payrolls to pay employees who are not legal US residents but who work on US soil and who benefit from US government services in a way that avoids American tax withholding, American social security contribution and American COBRA requirements.

Not surprisingly, it tends to work the same way abroad. When a US employer sends an American to work as an expatriate at some overseas place of employment, local host country tax withholding, social security contribution and mandatory benefits requirements usually apply, unless some special exception like a “social security totalization agreement” comes into play.

A big complication is that the US mandates do not always switch off just because an American sets out to work abroad. These US obligations can be “sticky,” following certain Americans overseas. An American working abroad can therefore be subject to both US and host country withholding/contribution requirements. When does this happen? The answer breaks down three ways: US tax withholding obligations versus US social security contributions versus US COBRA medical insurance continuation.

Pointer:
Understand, work through and comply with these mandates as to US taxpayers working abroad. Reconcile with corresponding local host country mandates.

Each monthly issue of *Global HR Hot Topic* focuses on a specific challenge to globalizing HR and offers state-of-the-art ideas for ensuring best practices in international HR management and compliance. White & Case’s International Labor and Employment Law practice helps multinationals globalize business operations, monitor employment law compliance across borders and resolve international labor and employment issues.

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US Tax Withholding and US Expatriates

The US is one of very few countries in the world that taxes its “tax subjects” on their worldwide (including foreign-sourced) income (subject to some exclusions, such as a credit for foreign taxes paid). This, though, does not necessarily mean that all employers must make *withholdings* to the US IRS on all foreign-sourced income that US taxpayers earn abroad. When, if ever, must an employer withhold income tax to the US IRS for an American taxpayer working overseas? To answer that, we first clarify three concepts:

- A “US taxpayer” includes both US citizens and US “tax residents” (for example, US “permanent residents”/green card holders), even if working abroad.
- “Working abroad” means having a principal place of employment outside the US, regardless of whether the employee works overseas as a company-designated expatriate, as someone living abroad for personal reasons or as a “trailing spouse.”
- A “US employer” is an employer who is a US “person.” This *includes* an employer entity incorporated in a US state even if it is registered overseas as a branch or representative office. But this *excludes* American companies’ wholly or majority-owned foreign-incorporated subsidiaries and affiliates not transacting business stateside.

US citizen. Under US Treasury regulations and IRS rulings (chiefly Treasury Reg. 31.3401(a)(8)(A-1b), (d-1) and IRS Rev.Rul. 92-106 (12/7/92)), employers must withhold and remit to the US IRS income tax of US citizens working abroad. But this mandate is subject to two vital exclusions: (1) the employer need withhold against a US employee working abroad only on income above the “foreign earned income exclusion,” which in 2011 was US\$92,900, and (2) the employer need withhold on income earned outside the US only if that income is not subject to withholdings under local withholding mandates imposed by the host country. That is, the employer need not withhold on income that the employee is required, under local law, to have withheld locally. So an employer need impose US withholding tax payments made to a US citizen working abroad only on income remaining after excluding both the foreign earned income exclusion and income subject to actual host country-mandated income tax withholdings.

Non-US-citizen US taxpayer. This same US withholding mandate also reaches US “tax subjects” working abroad who are *not* US citizens—but in that case, the two exceptions do not apply. That can mean double withholding: A non-US-citizen US taxpayer working abroad can easily be simultaneously subject to both local and US tax withholding. That said, though, employers can reduce US withholdings of non-citizen US taxpayers working abroad by the anticipated foreign tax credit they will be entitled to take on US tax returns.

Non-US employer. Surprisingly, the US IRS takes the position that this same analysis applies not only to US employers, but also even to *non-US employers*. See IRS Rev.Rul. 92-106 (12/7/92). That means a *non-US* employer of a US taxpayer working abroad is actually supposed to make US tax withholdings to the US IRS—even if the non-US employer transacts no business stateside. This is an aggressive position that raises problems. Few non-US employers operating outside the US have US taxpayer identification numbers with which they can make US IRS withholdings. And non-US employers operating abroad may not be in a position to know which of their employees may happen to be US taxpayers. For most non-US employers, *compliance* with this IRS withholding mandate may prove all but impossible. Indeed, IRS *enforcement* against non-US employers that transact no business in the US may be all but impossible as well.

US Social Security Contributions and US Expatriates

Our next question: When must an employer withhold and contribute to US social security for a US taxpayer working abroad? In contrast to US wage withholding law, US social security contribution law draws a sharp distinction between US (“American”) employers versus non-US employers. See US Tax Code §§ 1321(h), 3306(j)(3). US employers must contribute to US social security even for US taxpayers working abroad, unless the employer registers under and complies with one of the 24 US social security totalization agreements. (These 24 agreements, listed at www.ssa.gov, cover social security contributions only—not income tax withholding.)

Because social security law at the host country place of employment tends to require local contributions, a US employer of a US taxpayer working abroad not registered under a social security totalization agreement can be simultaneously subject to *two countries’* social security contribution mandates. However, a non-US employer—including even a US employer’s wholly or majority-owned foreign subsidiary or affiliate—has no obligation to contribute to US social security for US taxpayers working abroad. This means that as to expatriates, the US social security obligation drops out when an expat “localizes” onto a foreign affiliate entity payroll.

That said, sometimes US taxpayers working abroad *ask* to continue participating in US social security. Can a non-US employer affiliated with a US employer *elect* to contribute to US social security even when no contribution is required? The answer is yes, *if* the non-US employer’s US affiliate agrees to contribute to US social security for *all*—not merely some—US taxpayers working abroad for that particular foreign affiliate.

A similar analysis applies to unemployment compensation. See IRS Rev.Rul. 92-106 (12/7/92).

US COBRA and US Expatriates

Multinationals often find themselves parting ways with US taxpayers working abroad. Inevitably some expatriate postings fail, while others end without any US-domestic job for the expat to “repatriate” back to. Among the many issues that cross-border separations raise is the discrete question of medical insurance coverage continuation under US COBRA, the unique law that requires US employers to allow certain ex-employees to continue in medical insurance plans after termination—if the employee pays the premium. Because COBRA tends to have no counterpart under foreign laws, terminated US taxpayers (particularly American expats who return stateside right after termination) often look to COBRA for medical insurance continuation rights. Does COBRA grant rights here? There is no simple answer. Case law and interpretive memoranda are silent, requiring an analysis of the COBRA statute itself as codified under ERISA (the US federal statute regulating employee benefits plans) and the US tax code.

When a US taxpayer working abroad participates in *foreign* medical insurance plans—plans “maintained outside the US primarily for the benefit of non-resident aliens”—then ERISA does not apply: ERISA explicitly excepts these plans. Terminated American expats, therefore, get no medical insurance continuation rights under COBRA/ERISA if they participated only in foreign medical insurance plans. (Indeed, as a practical matter, a US employer would have a tough time extending COBRA benefits under a foreign employee medical insurance plan—foreign plans tend to require that beneficiaries be current employees.)

Conversely, COBRA/ERISA *would* appear to reach overseas American expats in medical insurance plans maintained stateside primarily for the benefit of Americans. This could include expatriate plans primarily for Americans working abroad.

Complicating this somewhat, a theoretical argument exists under the *US tax code’s* separate COBRA provisions that *tax* COBRA might extend abroad: The COBRA provisions in the US tax code do not contain ERISA’s exclusion for plans “maintained outside the United States.” But only the US IRS, not an employee, can impose a sanction for a violation of tax COBRA, and the foreign-employee coverage question seems unlikely to arise in US IRS proceedings.

At most, then, a US-based multinational should have to extend COBRA medical insurance continuation rights abroad, if ever, only to expatriate Americans in US “maintained” medical insurance plans that primarily benefit US residents. This might include expat medical plans. COBRA does not seem to reach foreign-maintained plans primarily for foreigners, even if some Americans participate in them.

Facilitating expat COBRA coverage. This analysis assumes a US multinational employer resists overseas COBRA coverage. A common scenario is the multinational *willing* to extend COBRA rights to a terminated American expat as part of a negotiated severance package—particularly where the terminating expat returns stateside upon separation. Where an employer is willing to facilitate COBRA coverage of a returning expat onto the employer’s main US domestic medical insurance plan (as opposed to a foreign or expat medical plan), then the employer may need to transfer the expat back onto its domestic US payroll for a final day worked. (US medical insurance plans tend to cover only ex-employees who participated on their final day worked.)

As a “best practice,” consider these issues and craft a consistent policy for US expat medical insurance continuation. Tell expats up-front what the policy is. Employers willing to offer COBRA coverage to expats should check their plans. Follow a consistent and fair approach to minimize discrimination claims and to avoid having to “reinvent” the COBRA “wheel” when terminating each American abroad.

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