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Agenda

- 1 Overview of shadow payroll & key concepts
- 2 Compensation collection
- 3 Shadow payroll execution
- 4 US shadow payroll specifics
- 5 Gross up calculations
- 6 Questions/wrap-up

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Shadow payroll overview

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What is shadow payroll?

One of the simplest explanations of shadow payroll:

A method of maintaining international tax compliance while an employee works abroad.

The reality – any payroll professional familiar with shadow payroll would undoubtedly attest, it is far more “COMPLEX” than simple

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The basics

Shadow payroll is a reporting mechanism used by payroll to meet the employer's obligation to report wages and withhold taxes

- Facilitates employer's obligation to report compensation and withhold payroll tax in the host location
- Reports wages and remits applicable taxes on wages that are deemed taxable in the host country
- No net pay or cash compensation is actually delivered to the assignee

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Why is shadow payroll important?

- Increased government regulation and payroll audits worldwide
- Push for correct and timely remittance of payroll taxes
- Maintain home country benefit/pension eligibility
- Capturing locally paid items

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Why is shadow payroll “complex”


- Tax Treatment**
 - Equalize
 - Tax Protection
 - Non-equalize
- Administration & processes**
 - Timing of payroll (parallel or arrears; country requirements)
 - Pay codes (imputed items)
 - Special Rulings (i.e., Netherlands 30% ruling)
 - Payment restrictions
 - Multi-currency
 - Policy and benefit considerations
 - Chargebacks; transfer pricing
- Reporting & Compliance**

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Why is shadow payroll “complex”

- Where to tax income?**
 - Equalize
 - Tax Protection
 - Non-equalize
- What should be taxed?**
 - Timing of payroll (parallel or arrears; country requirements)
 - Pay codes (imputed items)
 - Special Rulings (i.e., Netherlands 30% ruling)
 - Payment restrictions
 - Multi-currency
 - Policy and benefit considerations
 - Chargebacks; transfer pricing
- Which taxes are applicable?**
 - Federal
 - State, Local
 - Social



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Shadow payroll risks and challenges

Regardless of the chosen payroll delivery, the greatest challenge is the gathering and sharing of information by the home-country and host-country payrolls, including:

- Capturing payments made in the home country and/or host country, to ensure full reporting in both jurisdictions
- Identifying non-taxable income paid in the home country or host country which may be taxable in the other location

Inaccurate or incomplete systems and processes can lead to failure to:

- Control and authorize payments made in the home country and/or host country increasing the chance of duplicate reimbursements and non-compliance with international assignment procedures; and
- Meet the reporting and withholding obligations (and subsequent tax penalties)





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Key terms and shadow concepts

- Gross Up
- Tax Equalization
- Totalization Agreement & Certificate of Coverage (CoC)
 - International Social Security agreements, often called “Totalization agreements”, are bilateral agreements to prevent double taxation of income with respect to social security benefits
 - Certificate of Coverage – serves as proof of exemption for host country social taxes
- Imputed Income
- Economic Employer
- Permanent Establishment (PE)



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Key terms and shadow concepts (continued)

Home payroll	Host payroll	Split payroll or split pay
<ul style="list-style-type: none"> Long-term or short-term assignment Receives Home Salary plus additional assignment allowances as defined by the policy May be tax equalized, pays hypothetical taxes May participate in home country benefit plans Depending on host location, may be eligible for a Certificate of Coverage 	<ul style="list-style-type: none"> Typically a Long-Term assignment and is not tax equalized Receives Host Salary (in host currency) plus additional allowances Assignee pays actual taxes Company typically tax protects select allowances May be able to remain on home country benefit plans Assignee may be eligible for a Certificate of Coverage 	<ul style="list-style-type: none"> Home and Host company payroll Home payroll and portion of pay delivered via A/P. vendor Host payroll and portion of pay delivered by A/P. vendor A portion of pay is delivered in both locations Amount delivered in other location is deducted as post tax deduction from payroll

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Host country shadow payroll

When an employee working overseas remains on their home country payroll but a second payroll, or a shadow payroll, would simultaneously be run in their host country. This is the most common method for operating a shadow payroll.

Example: A U.S. employee working for a subsidiary in Argentina would be paid by the U.S. company while a shadow payroll would be done for their tax obligations in Argentina.

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Home shadow payroll

An employee working overseas is no longer actively paid by their home country payroll but instead is paid by the host country's payroll. The assignee, according to the work arrangement is still taxable in their home country, therefore a home shadow payroll is prepared to ensure taxes are calculated properly, as well as pension contributions and length of service benefits.

Example: The U.S. employee would be paid by the Argentinian company while a shadow payroll would be done for their tax obligations in the U.S.

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Split shadow payroll

An employee working overseas receives payment in both their home and host country payroll. This is most common in countries that require the payment of expatriate workers to occur in a local currency or where it may be convenient for the employee to receive some pay in the local currency.

Example: The U.S. employee would be paid by both the U.S. company in U.S. dollars and the Argentinian company in Argentinian pesos.

Mandatory Local Payment – Another complication with currencies is whether the country requires foreign workers to receive local pay. In countries like Brazil, the assignee must be paid in local currency.

Home (Split Shadow Payroll)

- Partial Payroll
- Shadow Payroll for Host Items
- Taxes & Social Security Due

Host (Split Shadow Payroll)

- Partial Payroll
- Shadow Payroll for Home Items
- Taxes & Social Security Due

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Shadow payroll considerations

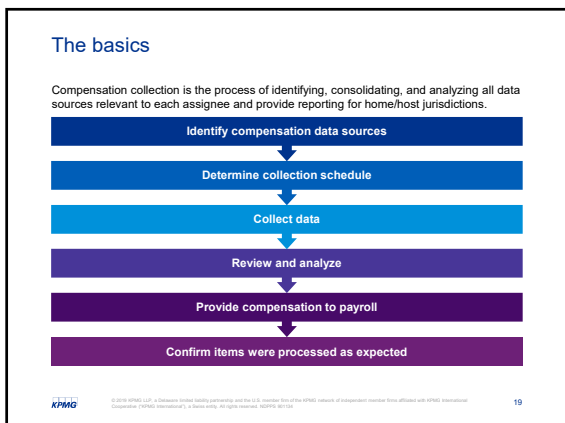
- Assignment duration
- Existence of an income tax treaty between the home and host location
- Existence of a totalization tax treaty between the home and host location
- Cross charging arrangement between home and host location of employment income
- Provision/types of policy elements provided to assignee
- Economic employer

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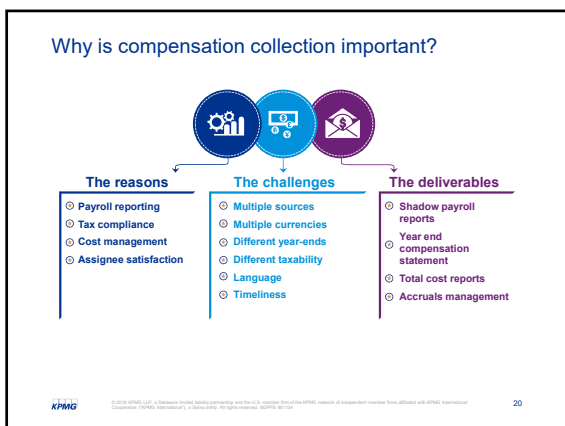
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Compensation collection

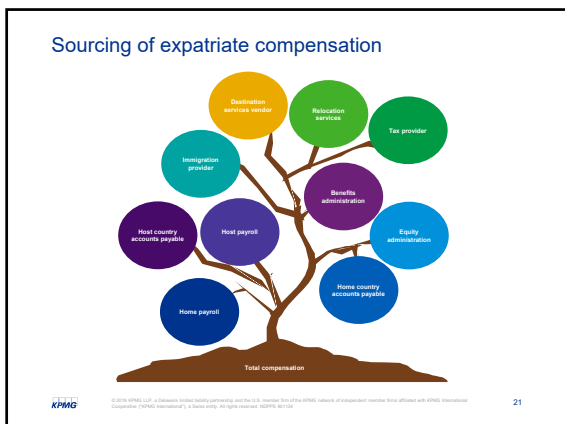
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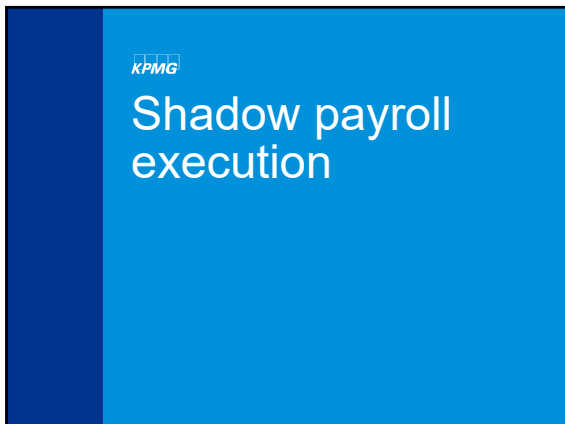
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When to run shadow payroll?

- Local wages and taxes must be recorded and paid to the proper authorities per the schedules legislated in that country. Additionally, tax year end dates are different across the globe
- Processing shadow payrolls on a monthly basis helps ensure compliance with local laws requiring "current" reporting of compensation earned, taxes due and remitted
- Shadow payrolls can also be used to maintain participation in pension and social insurance plans or to satisfy mandatory deductions (i.e. garnishments) or loans owed in the non-paying country

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Who to involve?

Legal <ul style="list-style-type: none"> Business Structure & Formation Capital & bank Accounts Employment Law Staffing Documents Immigration/Visas 	HR & Administration <ul style="list-style-type: none"> Compensation & Benefits Staff Officer Letters Expatriate Packages & LOAs Payroll & Related Compliance Immigration/Visa
Corporate Tax <ul style="list-style-type: none"> Business Structure & Formation Securement Agreements Transfer Pricing & PE Capital & Bank Accounts 	
Treasury <ul style="list-style-type: none"> Capital & Bank Accounts Payroll Funding Currency Restrictions 	Accounting <ul style="list-style-type: none"> Cross Charges Budgets & Accruals General Ledger

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Identifying taxable wages

- Assess assignment length and purpose to determine if assignment is taxable or not taxable;
- Review and identify the taxability of each element that the employee has received or has been paid to a third party on their behalf; certain pay elements may not be taxable if certain conditions are met such as assignment duration, beneficiary of payment, pay delivery, etc.
- Social security will be assessed independently from the taxability in shadow payroll. Depending on the Totalization Agreements (Certificate of Coverage) it may be required to set up shadow payroll for social security purposes even if there are no shadow payroll requirements from an income tax perspective.

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Convert taxable elements

- Convert the taxable elements to the shadow payroll currency using the FX rates specified by the company and/or government rates.
- Fluctuating currencies and inflation can be major challenges for employees working overseas, particularly in developing countries. This in turn may increase tax obligations but under a tax equalization plan, the employee should not see any decrease in salary despite increased amounts paid by the employer to cover certain costs.

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Process shadow payroll

- Process the shadow payroll, gross to net, while calculating the local tax obligations. Payroll needs to ensure taxable compensation reported for shadow purposes are not paid to the assignees.
- In order to identify shadow payroll it is advisable to include separate shadow pay codes. While this is not strictly necessary if payroll uses offsetting entries, it does make it easier to differentiate between assignees who receive payments and assignees who are merely on shadow payroll.

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What wages need to be reported?

- Worldwide income or income earned in country?
 - NOT all countries are the same
- Policy considerations
 - Long-term assignment
 - Short-term assignment
 - Commuter assignment
 - Localized/Permanent transfers

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Assignment-related compensation

Cash compensation

- Base salary
- Incentive compensation – period earned
- Equity compensation – period earned
- Goods and services (COLA)
- Housing allowance
- Relocation allowance
- Moving expense reimbursement
- Foreign incentive/hardship premium
- Foreign pension contribution
- Tax reimbursements
- Per diems

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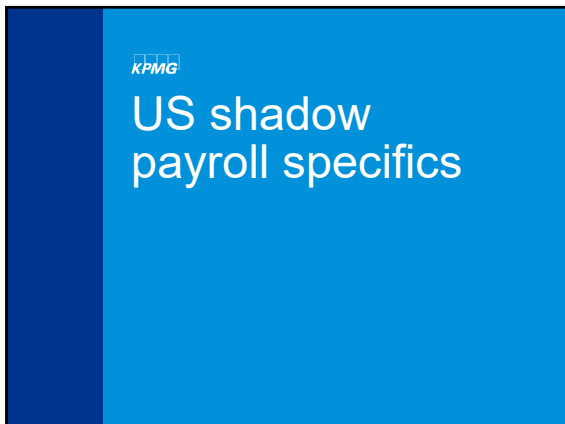
Assignment-related compensation (continued)

Noncash compensation

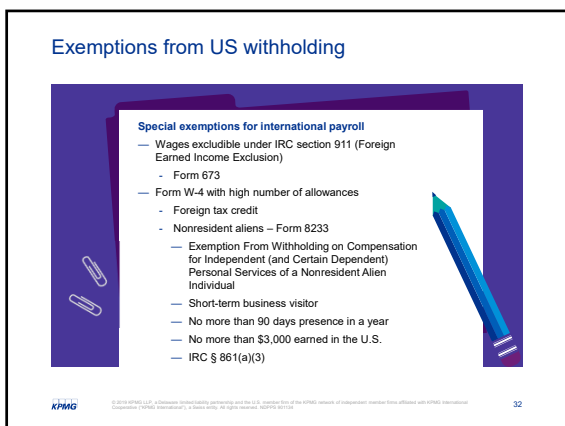
- Foreign fringe benefits
- Personal use of automobile
- Dependent education
- Language lessons/cultural training
- Tax return preparation
- Club memberships
- Shipment/storage of goods
- Home sale assistance
- Home leave

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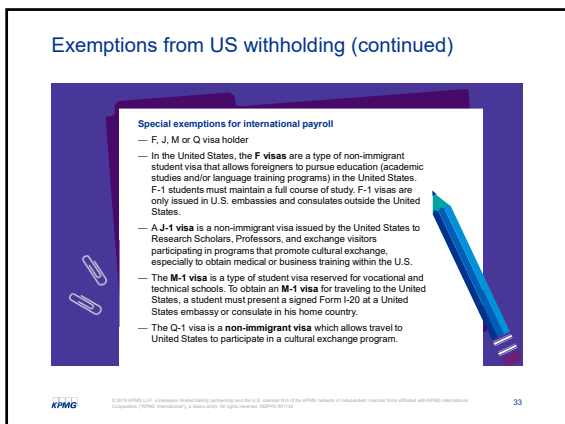
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Exemptions from US withholding (continued)

Special exemptions for international payroll

- Treaty dependent personal services exemption
 - The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States.
 - <https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-b-c>
 - 183 days
 - Compensation not borne by U.S. employer

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U.S. totalization agreement countries

<ul style="list-style-type: none"> — Australia — Austria — Belgium — Canada — Chile — Czech Republic — Denmark — Finland — France — Germany — Greece — Hungary — Ireland — Italy 		<ul style="list-style-type: none"> — Japan — Netherlands — Norway — Poland — Portugal — Slovak Republic — South Korea — Spain — Sweden — Switzerland — United Kingdom
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Copies of the Totalization Agreements may be obtained from the Social Security Administration

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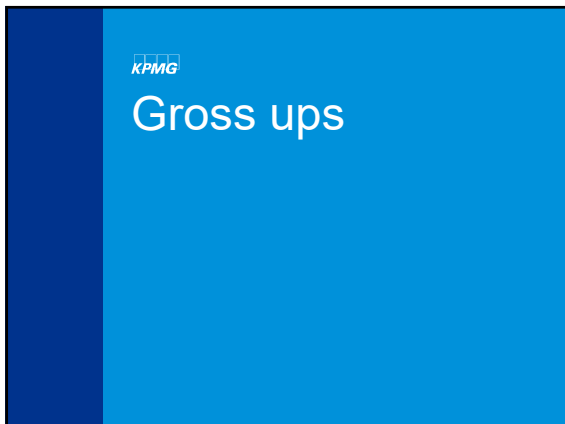
Claim of right

Claim of right doctrine – IRC § 1341(a)

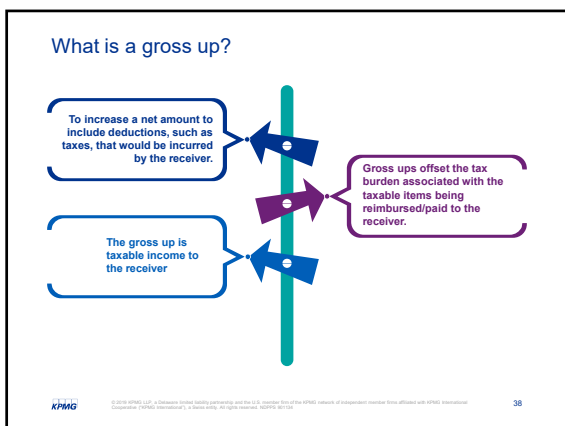
- The tax treatment of an amount that was previously included in taxable income because the taxpayer appeared to have a right to the income, but subsequently is returned to the payor of the income, is governed by the “claim of right” doctrine (IRC section 1341(a))
- An item was included in gross income for a prior tax year (or years) because it appeared that the taxpayer had an unrestricted right to the item;
- A deduction is allowable for the tax year because it was established after the close of such prior tax year (or years) that the taxpayer did not have an unrestricted right to the item or to a portion of the item; and
- The amount of the deduction exceeds \$3,000

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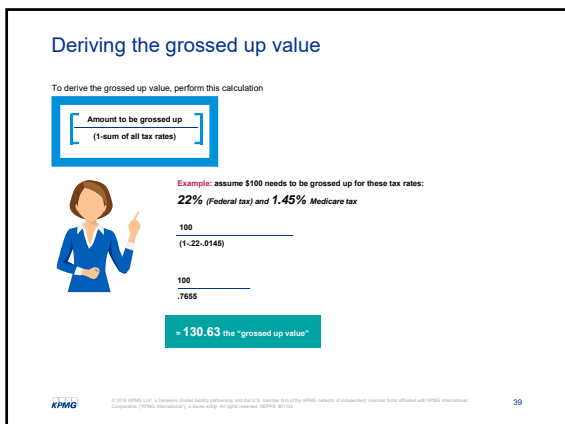
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Separating the gross up

To isolate just the gross up amount (income), perform this calculation

$$\left[\frac{\text{Amount to be grossed up}}{1 - \text{sum of all tax rates}} \right] \text{ minus } \left[\text{Amount to be grossed up} \right]$$

Example: assume \$100 needs to be grossed up for these tax rates:
 22% (Federal tax) and 1.45% Medicare tax

100	-	100
(1-22-0145)		
100		-100
.7655		
= 130.63		

= 30.63 the "gross up" separated out



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Separating the taxes


To identify the taxes related to the grossed up amount, perform this calculation:

$$\left[\frac{\text{Amount to be grossed up}}{1 - \text{sum of all tax rates}} \right] \times \begin{matrix} \text{Tax rate 1} \\ \text{Tax rate 2 (if applicable)} \\ \text{Tax rate 3 (if applicable)} \end{matrix}$$

Example: assume \$100 needs to be grossed up for these tax rates:
 22% (Federal tax) and 1.45% Medicare tax

100					Math check:
(1-22-0145)					30.63 Gross up income separated
					(30.63) less taxes
					= \$0
100			x .22	= 28.74 (in Federal tax)	
.7655			x .0145	= 1.89 (in Medicare tax)	
= 130.63					

= 30.63 represents the 22% + 1.45% in taxes




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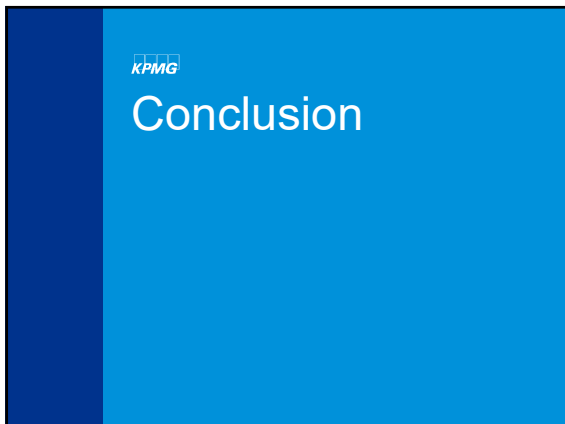
Tips for calculating US gross ups

- 1** • Not all gross up calculations are the same tax rates or the same tax withholdings (i.e. not all assignees may be subject to FICA or state taxes)
- 2** • Confirm your FICA caps (Social and Medicare) prior to performing your GU calculation
- 3** • Ensure your state withholding and local withholding rates are accurate
- 4** • Review federal GU rates. Client may use statutory flat rates or rate may be based on individual assignee earnings.
- 5** • Review accruals, if available to ensure GU are not over reported.

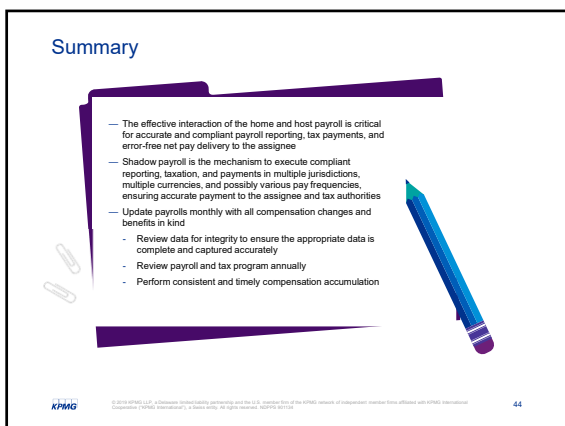


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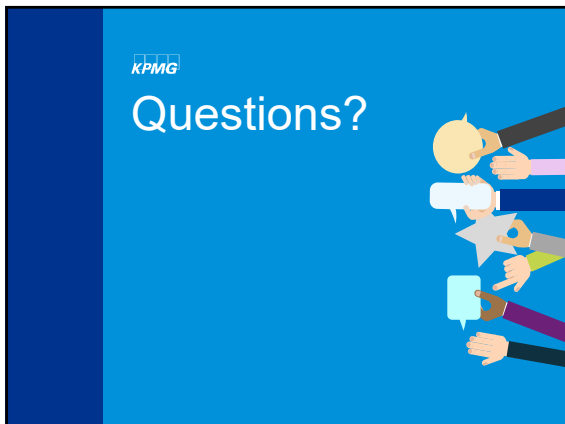
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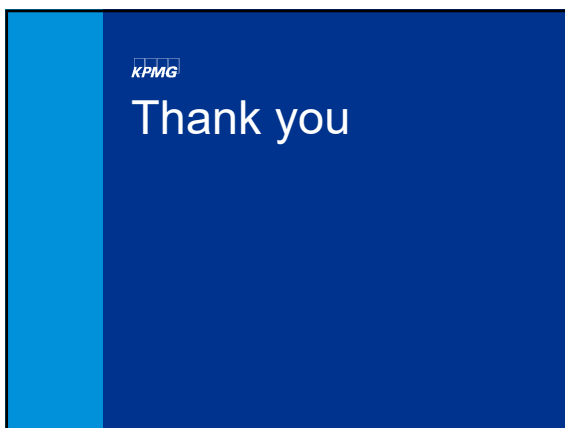
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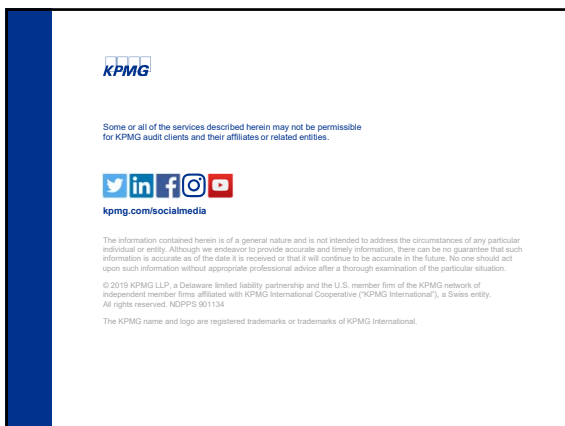
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