

Titus Tax Alert!

The IRS, foreign revenue authorities and immigration departments are increasing their scrutiny of business travelers, which is heightening the tax and business risk for the organization as well as for the employee. Multinational companies need to be cognizant of the fact that the Internal Revenue Service (“IRS”) is targeting US “accidental” permanent establishments (“PE”). If a corporate taxpayer is concerned that an unintended or accidental PE has been created, it should consider implementing an internal audit in order to correct any unintended PEs and mitigate the resulting costs.

In addition, the IRS recently established a Compliance initiative Project (“CIP”) to review samples of Forms 1120-F, Income Tax Return of Foreign Corporation, for foreign corporations that have requested refunds of withholding taxes for the purpose of determining whether the foreign corporation may have a taxable trade or business or PE in the US.

Accidental PE Issue. Business travelers who operate outside of the original scope of duties – or accidental expatriates – may result in a “permanent establishment,” which is a tax treaty concept and refers to the establishment of a taxable presence in another country. The creation of an unintended or accidental PE represents a growing area of concern for many multinational companies as a PE may require a company to register as a taxpayer, pay taxes and report earnings in a jurisdiction in which the organization never intended to establish a taxable presence.

Revenue and immigration authorities in various countries are sharing information, thereby making it easier to detect unreported PEs and other violations. Each country has its own laws and other criteria to determine whether or not a corporation has a tax liability in a particular jurisdiction. Moreover, many local tax authorities are broadening the definition of a PE in order to increase tax revenues for their country.

The factors that result in a PE vary by treaty and country. The following items exemplify common factors that are considered in determining whether a PE has been created:

- Length of stay of expatriate employee(s);
- Number of visits to the country;
- Whether the expatriate has the authority to sign contracts on behalf of their employer and, if so, whether the expatriate habitually does so;
- Terms of the expatriate assignment;
- The entity that pays for the expatriate employee costs; and
- The entity that claims a corporate tax deduction for such employee costs.

If it is asserted that a PE exists, then income generated by the subject employee’s activities in the visited country may be subject to that country’s corporate income tax. Thus, the PE creates

a financial burden for the employing company, including a corporate income tax liability and the administrative burden of corporate tax filings in a new jurisdiction.

As part of its approach to risk management, companies are advised to assign responsibility within the organization to monitor the activities of international corporate travelers as well as the frequency and duration of their visits to foreign countries. In conjunction with the establishment of a tracking function, the corporation may further mitigate risks by instituting formal policies that cover the establishment of:

- A formal tracking system for cross-border employees.
- Proper procedures to comply with tax reporting, withholding and immigration filing requirements.
- A plan to inform employees about new travel policies.
- Periodic training of employees to ensure they understand the issues and requirements.
- Procedures for handling accidental expatriates to avoid the risk of creation of a permanent establishment.

Results of Accidental US PE. If a PE is deemed to exist in the U.S., all applicable US tax laws apply. Further, the “dependent personal services” article of a related income tax treaty may no longer be used to exempt the worker’s U.S source compensation from U.S. taxation.¹ In such scenarios, U.S. tax law imposes U.S. payroll reporting and may impose tax withholding obligations on the employer. In addition, the employer must issue a Form W-2 to report the employee’s wages, and the employee generally must file a Form W-4 to inform the employer of federal income tax withholding choices. Applicable state income tax withholding forms also would need to be completed by the employee as required. Further, the foreign corporation will be required to file a Form 1120-F, U.S. Income Tax Return of a Foreign Company, to report its taxable income derived from U.S. sources.

Employment Taxes.

Withholding on Compensation. Compensation paid to foreign employees is subject to wage withholding. More specifically, effectively connected income in the form of compensation is taxed on a net basis (i.e., with appropriate allowance for deductions incurred in earning the income) at the graduated income tax rates.²

¹ The dependent personal services article generally requires that (i) the individual be a tax resident of the home country and a nonresident alien of the United States; (ii) the time spend in the United States by the individual is less than 183 days in a 12-month period; (iii) the employer of the individual is not resident in the United States; and (iv) income paid to the individual is not derived from a PE or a fixed place of business the employer has in the United States.

² IRC section 871(b).

Items that are effectively connected with the conduct of a trade or business within the US are exempt from withholding if appropriate documentation is presented to the withholding agent (e.g., Form W-8ECI).

Therefore, wages paid for services performed in the United States generally are subject to Federal income taxes and the Federal Unemployment Tax Act (“FUTA”) taxes regardless of the individual’s citizenship. Exceptions may be found in income tax treaties

Compensation Categories. US source compensation includes wages, but also may include the following:

- Stipends
- Honoraria
- Per Diem reimbursements or fees
- Lecture fees
- Registration fees
- Fees for completed articles, papers or reports
- Fees for workshops
- Fees for translation services
- Consulting fees
- Research fees
- Procurement fees, e.g., purchasing goods such as books, equipment, software, etc.
- Advertising fees
- Membership Dues

Social Security and Medicare Taxes. In general, US social security or the Federal Insurance Contributions Act (“FICA”) and Medicare taxes apply to payments of wages for services regardless of the citizenship or residence of either the employee or the employer. Thus, if a foreign national works as an employee in the US, they are required to pay social security and Medicare taxes in most cases. All taxable wages are subject to Medicare tax. These taxes are deducted from each wage payment, and must be deducted even if the foreign national does not expect to qualify for social security or Medicare benefits.

International Social Security (Totalization) Agreements. The US has entered into social security agreements (also referred to as “Totalization Agreements”) with certain foreign countries to coordinate social security coverage and taxation of workers employed for part or all of their working careers in one of the subject countries. Under these agreements, dual coverage and dual contributions (taxes) are eliminated. The agreements generally ensure that social security taxes are paid only to one country.

Generally under these agreements, the individual is subject to social security taxes only in the country where he/she is working. However, if the individual is temporarily sent to work for the same employer in the US and their pay would normally be subject to social security taxes in both countries, most agreements provide that the individual remain covered only by the social security system of the country from which they were sent.

Certificate of Coverage. To establish that one's pay is subject only to foreign social security taxes and is exempt from US social security taxes (including the Medicare tax) under the agreement (or vice-versa with respect to a US resident), a certificate of coverage should be requested from the appropriate agency of the foreign country (or from the US Social Security Administration with respect to US resident employees).

Withholding Agent/Depositing and Reporting Requirements. A withholding agent is any person that has the control receipt, custody, disposal or payment of an item of a foreign person subject to withholding, including a lessee, mortgagee, employer or the payor of dividends.³ In summary, a withholding agent is the last person in the US who handles an item of income before it is paid over to a foreign person. The withholding agent is required to deposit any withheld tax in a Federal Reserve or other authorized bank.⁴ A withholding agent who fails to withhold will be liable for the requisite tax, penalties and interest.⁵ Thus, the employer is liable for remitting employment taxes whether or not such amounts were actually withheld from the employee's wages. If certain procedures are followed, a withholding agent may rely on documentation provided by the payee indicating that no withholding is required.

Employers that fail to meet the above obligations may be subject to significant penalties for late deposits and late filing.

Other Income Subject To Withholding - Interest, Dividends and Other Periodic Payments. In general, the gross amount of any fixed, determinable, annual or periodical ("FDAP") income is subject to a 30 percent withholding rate (or lower treaty rate).⁶ In general, the 30 percent withholding regime is required if the following conditions are met:⁷

1. The recipient is a foreign person;
2. The amount paid is US source income;
3. The amount paid is FDAP income (i.e., generally passive investment income from interest, dividends, royalties and some rents);
4. The amount paid is not income effectively connected with a US trade or business;

³ Treas. Reg. section 1.1441-7(a).

⁴ IRC section 6302(c).

⁵ IRC section 1461.

⁶ IRC sections 871(a).

⁷ See IRC sections 871(a), 1441 and 1442.

5. The payor or some agent of the payor is a withholding agent; and
6. No exception applies.

As mentioned above, the 30 percent withholding rate may be reduced by a treaty if appropriate forms (e.g., W-8BEN or W-8ECI) are provided by the recipients in advance of payment. The withholding agent must file an annual return on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and a Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding, with respect to each foreign recipient.

Corporate Income Tax. At the corporate level, a Form 1120-F, U.S. Income Tax Return of a Foreign Company, must be filed to report income attributable to a PE. The Form 1120-F is an income tax return rather than an information return, and, therefore, the foreign corporation must compute a tax liability on the form.

Form 1120-F must be filed on a timely basis and in a true and accurate manner in order for a foreign corporation to take deductions and credits against its effectively connected income. For these purposes, Form 1120-F is generally considered to be timely filed if it is filed no later than 18 months after the due date of the current year's return. An exception may apply to foreign corporations that have yet to file Form 1120-F for the preceding tax year. These filing deadlines may be waived, in limited situations, based on the facts and circumstances where the foreign corporation establishes to the satisfaction of the Commissioner that the foreign corporation acted reasonably and in good faith in failing to file Form 1120-F. If a Form 1120-F is not filed within 18 months after the due date, the IRS may disallow deductions and credits on returns that are filed after that date.

IRS Compliance Initiative Project with respect to Forms 1120-F. The IRS recently established a Compliance Initiative Project ("CIP") to review Forms 1120-F, Income Tax Return of Foreign Corporation, that are filed to claim refunds for taxes over-withheld at source, have been filed on a protective basis or which may reveal the presence of an accidental PE. The IRS is concerned that foreign corporations are failing to properly report and pay U.S. taxes and also that examiners may not have been adequately addressing the PE issue in prior years.

Withholding agents may not always properly withhold the correct amount of tax on payments to foreign recipients, such as if a foreign corporation fails to provide a proper W-8BEN to the withholding agent, the withholding agent uses an incorrect treaty withholding rate, payments are misclassified as other than FDAP or when other errors occur.

A withholding agent is required to issue a Form 1042-S, Foreign Person's US Source Income Subject to Withholding, to a foreign corporation, and delineate payments made during the preceding calendar year that were subjected to withholding taxes and the amount of tax withheld. If a foreign corporation believes taxes were over-withheld by the withholding agent,

the foreign corporation must apply for a refund of any taxes reported on Form 1042-S that it believes were over-withheld by filing a Form 1120-F.

Based on this recent initiative by the IRS, Forms 1120-F have been selected for examination in cases where the only activity with respect to these returns has been a request for a refund of over withheld taxes or where a Form 1120-F has been filed “protectively” to preserve deductions and credits. Based on the Internal Revenue Manual procedures related to classifying or screening Forms 1120-F,⁸ the agents are required to seek, and are doing so aggressively, significant detailed information unrelated to the item of income subject to withholding including:

- An organizational chart of the taxpayer's worldwide operations, specifying all related entities located in the U.S. that the taxpayer has control over or the right to control.
- The physical address for any assets located in the U.S. that are owned (wholly or in part) by the taxpayer.
- All lease agreements for any items leased by the taxpayer in the U.S.
- All purchase agreements for any items purchased by the taxpayer in the U.S.
- The name and contact information for any U.S.-based person used to market or advertise the company's products and any written agreements, as well as the details of any verbal agreements.
- The name and contact information for all the company's U.S. clients in x years and the gross sales to each client.
- The rationale for the taxpayer's filing a protective return, including the facts and basis on which the taxpayer believes it does not have a U.S. trade or business or PE.

The information gathered by the IRS from these examinations will be shared with LMSB and SBSE examiners across the country for use in their ongoing examinations. The IRS will utilize all information obtained to analyze the foreign taxpayer and its U.S. business relationships.

For more information concerning the issues above, please contact Wendi Hangebrauck, Tax Practice Director, (312) 268-2122, wendi.hangebrauck@titus-us.com

⁸ Internal Revenue Manual section 4.1.8.2.5 (10-24-2006) and 4.1.8.2.6 (10-24-2006).