BENEFITS & COMPENSATION INTERNATIONAL

TOTAL REMUNERATION AND PENSION INVESTMENT

How a US Organization Can Improve its Expatriate Tax Program

James P. Klein and Frederick A. Brodie

Jim Klein is counsel at Pillsbury in New York, where he advises companies on the international taxation of executive compensation and benefits. He was previously a partner with Deloitte Tax LLP. Earlier in his career, Mr Klein was a Vice President in Towers Perrin's New York office and the firm's national practice leader for retirement plans and executive benefits. He has a BA from Fordham University, a JD from Columbia University Law School and an LLM in taxation from New York University Law School. Mr Klein is a past chairman of the International Employee Benefits subcommittees of two American Bar Association Sections and is a founding member and past chairman of IPEBLA.

Fred Brodie is a litigation partner in Pillsbury's New York office. He represents both plaintiffs and defendants in litigation and arbitration concerning commercial and contract matters, fiduciary issues, employment and employee benefit disputes, and appeals. His experience includes defending lawsuits concerning expatriate tax equalization. Mr Brodie has been ranked by Chambers USA as a Leading Lawyer in ERISA litigation for four consecutive years (2007-10). He has a BA, magna cum laude, from Brown University and a JD from Yale Law School.

A multinational company's interests can circle the globe. Frequently, the company must reallocate its resources and move employees from one country to another. For employees, an international transfer could result in significant tax benefits or a major tax hit. For example, a US employee dispatched to a high-tax country like Belgium, Germany or Finland would be out-of-pocket for additional income taxes, whereas a US employee lucky enough to be reassigned to the Republic of Korea, New Zealand or Paraguay would most likely experience tax savings.

Recognizing the vagaries of tax rates, multinationals have adopted programs or agreements to smooth the tax effects of expatriation. By adopting an expatriate tax program, a multinational company seeks to ensure that its employees' decisions to accept expatriate assignments are tax-neutral. These programs create tax-neutrality by adjusting the tax burden of living in the host country (where the employee has been assigned to work) to match what the employee would have experienced in his/her home country where the employee ordinarily resides and works).

Ideally, the expatriate tax program is carefully constructed and delineates clearly the rights and obligations of the employer and the expatriate employee. In practice, however, many programs that we have seen suffer from significant drafting deficiencies. Through amendments, multinationals can:

- avoid costly and distracting litigation with expatriates;
- save money by recovering excess tax payments; and
- promote equity among the international workforce by ensuring that expatriates are not harmed by, and do not benefit from, host-country taxation.

We suggest six steps that multinational companies can take to improve their expatriate tax programs.

STEP ONE: ADD GOVERNANCE PROVISIONS

Unless they provide employee benefits, expatriate tax programs are not subject to ERISA*. Nonetheless, they can benefit from being structured like ERISA plans.

Under ERISA, almost all US employee benefit plans have a governing body – usually a committee composed of knowledgeable and experienced executives – which is responsible for interpreting the plan's terms, administering the plan's operation and resolving disputes with participants (or considering appeals from the decisions of an outside provider). The plan document almost always affords the committee discretion in performing those functions. If the plan administrators possess such discretion, the Supreme Court has ruled, their decisions must be reviewed with deference under the "abuse of discretion" or "arbitrary and capricious" standard,[1] which is the "least demanding" judicial yardstick for reviewing administrative action.[2]

The Supreme Court recently discussed the pluses of such a system, which include efficiency (avoiding costly

* Employee Retirement Income Security Act of 1974, as amended

litigation), predictability (relying on the expertise and experience of plan administrators) and uniformity (allowing a company to interpret its plan the same way in different jurisdictions).[3] In short, for ERISA plans, governance is pretty much universally acknowledged to be a Good Thing.

Against that background, we are continually surprised to see expatriate tax programs with incomplete governance provisions that do not contain mechanisms for dispute resolution. Sometimes, the program will simply include a statement that the interpretation of the administrator is final. Without a complete governance provision, if an expatriate employee disagrees with the company over the tax adjustment, he/she is free to sue the company. If the expatriate sues in a US federal court (as opposed to any other home or host country whose judicial system may be found attractive), the company's interpretation of its own expatriate tax program will receive no deference. Indeed, under the principle of "construction against the drafter," the program might be interpreted in whatever way is most favorable to the suing employee.

From a governance perspective, then, it makes sense to have an expatriate tax program look more like an ERISA plan. The right and responsibility to interpret it and resolve all disputes should be afforded to a committee. The committee should be granted discretion in interpreting and administering the program, finding facts and resolving disputes. The committee should have a procedure for meeting and making decisions. There should be an administrative appellate process, too, since administrative appeals tend to narrow and focus the issues.

If those reforms are adopted, an expatriate tax program committee's pronouncements should receive deference from the courts. After all, it is a contract. As contracting parties, the expatriate employees are entitled to receive only what the contract gives them. If the contract provides discretion to the committee, that discretion should be taken into account by a reviewing court. Although not tested judicially in the specific context of an expatriate tax program, that logic holds true in the analogous case of a "top-hat" plan – an unfunded deferred compensation program for highly-compensated executives that is exempt from most provisions of ERISA.[4] When a top-hat plan contains a contract term giving the administrator discretionary authority, that provision has been given effect through deferential review of the administrator's decisions for "abuse of discretion,"[5] "good faith,"[6] or "reasonableness."[7]

STEP TWO: ADOPT JURISDICTIONAL CLAUSES

Aside from the absence of administrative governance provisions, expatriate tax programs often do not contain clauses that select a forum, law or mode of dispute resolution. This means an expatriate employed by a multinational corporation with locations around the United States could sue the company in a plaintiff-friendly forum and demand a jury trial.

As part of its expatriate tax program, a multinational company should therefore include clauses:

– choosing binding artibration or selecting the jurisdiction where any lawsuit must be brought (for instance, the federal or state court of the place where the expatriate was hired);

– selecting the law under which the program is interpreted and governed (for instance, the law of the state where the company's home office is located); and

– providing that participants waive the right to trial by jury.

This should avoid complications later.

STEP THREE: REQUIRE TAX EQUALIZATION

Tax adjustment under an expatriate tax program typically is a multi-step process, which operates on a continuing basis while the employee is abroad. For example, a multinational company's program might run as follows:

1. The company pays the expatriate's host-country taxes.

2. Where necessary, the company advances tax payments to the expatriate's home country.

3. The company deducts "hypothetical home-country taxes" from the expatriate's paychecks, and keeps those amounts. Hypothetical home-country taxes are not paid to any tax authority; rather, they are the company's estimate of what the employee's withholding would be if he were not an expatriate.

4. After the tax year ends, an accounting firm selected and paid by the company calculates the expatriate's "stay-at-home tax." The stay-at-home tax is similar to the hypothetical home-country tax, except that it is usually based on tax returns prepared by an outside accounting firm, using consistent determinations of home- and host-country taxation for all those executives participating in the program.

5. Comparing items 1-4, the outside accountants conduct an equalization or "true-up" to determine who owes what to whom. The goal is to ensure that expatriate employees shoulder the same tax burden while working abroad that they would if they were working in their home country.

In theory, this process could result in either the expatriate or the company owing money to the other. However, some expatriate tax programs require that the tax equalization process begin with a request or submission by the expatriate. That structure, in effect, makes tax equalization optional: Expatriates will request a tax equalization if they think the company owes them money, but otherwise will lie low and hope the company does not realize they are unequalized. As a result, multinational companies may not recover the funds they advance to expatriates for tax payments.

The tax equalization process should be commenced by the company on a prompt and timely basis. The company should not wait for an expatriate to make the first move. Expatriates' participation in the expatriate tax program should be mandatory (and it usually is intended to be). Tax equalizations should be monitored to make sure the company gets its fair share of any

favorable host tax treatment. If the expatriate owes the company money as the result of a tax equalization, the expatriate should be required to pay up. If the expatriate does not pay, the program should provide the company with the ability to deduct outstanding amounts from the expatriate's compensation. As a fail-safe, the company should be authorized to sue the expatriate for unpaid expatriate tax program obligations.[8]

STEP FOUR: DEFINE "HOME COUNTRY"

Like Mehram Karimi Nasseri, who famously resided in Charles de Gaulle International Airport for 18 years, one expatriate we encountered claimed to have no "home country." Instead – unlike Mr Nasseri – this expatriate owned homes in three different countries and carefully structured his travels so he did not stay in one place long enough to owe taxes.

That sort of shenanigan should not be sufficient to circumvent an expatriate tax program. Each program should provide that every expatriate employee must have a home country for tax equalization purposes. The program should define "home country" so that it is readily determinable (e.g., the last country of permanent residence) and an expatriate's home country should be difficult to change during any one assignment. If the employee claims international homelessness, the expatriate tax program should select a default country – presumably either the United States or whatever country serves as the multinational company's home base.

STEP FIVE: REQUIRE INFORMED CONSENT

While most companies with international assignees have adopted an expatriate tax program, in some cases the policy is not fully distributed to the expatriates. As a matter of course, expatriates should be given a copy of the program. Further, as part of their expatriation package, employees living abroad should be required to sign an acknowledgement stating that they have read the program's terms and conditions and will comply with them, including the tax equalization procedure.

We do not anticipate that informed consent will deter workers from seeking expatriation. Most multinationals pay expatriates a bonus or premium to compensate them for the hardship of living away from home.

STEP SIX: DO NOT DELAY SETTLEMENT

Expatriate tax programs usually are not intended to become deferred compensation plans for US tax purposes. Nonetheless, employers should keep in mind that, to avoid the complex requirements of §409A of the Internal Revenue Code*,[9] the program should generally settle tax equalization within two years after the year of the appropriate tax return filing.[10] Further adjustments may be permitted for subsequent audit or litigation developments.

THE TAKE-AWAY

Expatriate tax equalization is an arcane subject, and multinational companies should anticipate disputes. Companies should review their expatriate tax programs to ensure that the plans contain governance provisions that afford a governing committee discretion in their interpretation and application; the right to jury trial has been waived and an appropriate arbitral or legal forum for dispute resolution has been selected; tax equalization is mandatory; the program identifies a home country for each expatriate; each expatriate's informed consent to participation in the program is obtained; and tax equalizations are settled within two years after the appropriate tax year, in compliance with §409A of the Internal Revenue Code. Ω

* For further information, please see 'The International Implications of §409A and its Impact on Multinational Companies' by Frances Phillips Taft, *B&C International*, January/February 2008 and 'How Canadian Employers of US Citizens Can Reduce their US Tax Liability' by Candice M. Turner, *B&C International*, March 2011.

References

1. *Metropolitan Life Ins. Co. v. Glenn*, 554 U.S. 105, 128 S.Ct. 2343, 2348 (2008); *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 111 (1989).
2. *Williams v. International Paper Co.*, 227 F.3d 706, 712 (6th Cir. 2000).
3. *Conkright v. Frommert,* 130 S.Ct. 1640, 1649 (2010).
4. ERISA §201(2), §301(a)(3), §401(a)(1), 29 U.S.C. §1051(2), §1081(a)(3), §1101(a)(1).
5. *Sznewajs v. U.S. Bancorp Amended and Restated Supplemental Benefits Plan*, 572 F.3d 727, 734 (9th Cir. 2009); *Olander v. Bucyrus-Erie Co.*, 187 F.3d 599, 606-08 (7th Cir. 1999).
6. *Craig v. Pillsbury Non-Qualified Pension Plan*, 458 F.3d 748, 752 (8th Cir. 2006); *Goldstein v. Johnson & Johnson*, 251 F.3d 433, 444 (3d Cir. 2001).
7. *Bender v. Xcel Energy, Inc.*, 507 F.3d 1161, 1167 (8th Cir. 2007).
8. See, e.g., *Tyco Electronics Corp. v. Davis*, 895 A.2d 638 (Pa. Super. 2006); *General Elec. Technical Servs. Co. v. Clinton*, 173 A.D.2d 86 (N.Y. App. Div. 3d Dep't 1991).
9. 26 U.S.C. §409A.
10. See Treas. Reg. §1.409A-1(b)(8)(iii).

Copyright © Pension Publications Limited 2011.

Reproduced from Benefits & Compensation International, Volume 40, Number 9, May 2011.
Published by Pension Publications Limited, London, England.
Tel: + 44 20 7222 0288. Fax: + 44 20 7799 2163. Website: www.benecompintl.com
Produced by The PrintZone (www.theprintzone.co.uk).

Prior written permission required to reprint in bulk.