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I. Introduction

Employers and employees frequently enter into tax equalization agreements when employees perform services abroad.[1] The purpose of a tax equalization agreement is to make the assignment tax-neutral to the employee — that is, the employee's earnings from the assignment, net of taxes, are intended to be the same as they would be if the employee had performed the services in the United States.[2] Drafting an effective tax equalization agreement requires the parties to balance comprehensiveness with relative simplicity and finality. If parties disagree about their respective rights and obligations under a tax equalization agreement, they should carefully weigh the pros and cons of taking the dispute beyond the preliminary stages.

II. Taxation of Wages and Related Income

A. General Overview

Wages, cash bonuses, and phantom equity awards are subject to federal income tax at ordinary income rates, generally in the year when the employee receives the income.[3] State and local income taxes are generally deductible for purposes of federal income tax, although deductibility may be limited for purposes of the alternative minimum tax.[4] Employees are also subject to Social Security and hospital insurance (collectively, Social Security) taxes.[5] Employers are generally required to withhold employees' federal income and Social Security taxes.[6]

B. Foreign-Source Income

U.S. citizens and tax residents are generally subject to federal income tax on their worldwide income.[7] Taxpayers may be able to claim a credit for foreign taxes paid on income for services performed outside the United States.[8] The foreign tax credit is generally limited to the same portion of the federal income tax that the taxpayer's

[1] Tax equalization payments can be addressed in a separate document or clause within a larger agreement that addresses other aspects of an employee's foreign assignment, which may include location, duration, title, responsibilities, additional payments (such as housing and car allowances), and preparation of the employee's tax returns. For ease of reference, this article refers to all arrangements addressing tax equalization as "agreements," even when they appear as a clause in an agreement that also addresses other issues.

[2] The hypothetical tax liability that the employee would owe if she had performed the services in the United States is sometimes referred to herein as the baseline tax liability.

[3] *See* section 451 and reg. section 1.451-1(a). Under constructive receipt rules, income may be taxed in the year it is made available to the employee, even if it is received in a later year. *See* reg. section 1.451-2.

[4] *See* sections 164 and 56(b)(1)(A)(ii).

[5] *See* section 3101(a) (Social Security) and (b) (hospital insurance).

[6] *See* sections 3402 and 3102. Also, employers are generally required to withhold employees' state and local income taxes.

[7] As discussed below, a taxpayer may be able to exclude some foreign-source income and housing allowance from gross income. *See* section 911.

[8] *See* sections 901 and 862(a)(3).

foreign-source taxable income bears to her entire taxable income for the same tax year.[9] Thus, a taxpayer cannot claim an FTC that exceeds her federal income tax liability. Any excess FTCs (that is, credits limited under section 904(a)) are carried back one year and forward for 10 succeeding tax years.[10] Tax treaties executed by the United States generally do not restrict a host country's right to tax local earnings of citizens and residents of the home country, or the taxpayers' ability to claim credits in their home country for host-country taxes paid on those earnings.[11]

U.S. citizens and tax residents working for a U.S. employer are also generally subject to Social Security taxes on their worldwide income.[12] The United States has entered into totalization agreements with several countries to avoid double taxation of income in connection with Social Security taxes. Totalization agreements generally waive Social Security taxation in the host country if the employee (1) is sent there by an employer from the home country, (2) is not expected to work in the host country for longer than five years, and (3) continues paying Social Security taxes in the home country and obtains a certificate of coverage from the home country.[13]

III. Drafting Considerations

The purpose of tax equalization is to make an employee indifferent, from a tax perspective, between performing the assignment in the United States or abroad. A tax equalization agreement typically states the intent to make the assignment tax-neutral to the employee and calls for payments, either from the employer to the employee or vice versa, that may be necessary to leave the employee with the same net-of-tax earnings she would have had if she had performed the assignment in the United States. A comprehensive tax sharing agreement should address various substantive and procedural issues, including the ones discussed below.

A. Substantive Issues

At first blush it may appear that an employee would never be required to make a payment to the employer under a tax equalization agreement, because the United States taxes its citizens and tax residents on their worldwide income. If an employee is sent to a jurisdiction that has a higher tax rate than the United States, the employee would expect the employer to pay the amount by which the foreign taxes exceed the U.S. taxes.[14] If an employee is sent to a low-tax jurisdiction, the employee's tax burden would appear to not be reduced, because the United States would tax the employee on her worldwide income (and grant credit for foreign income taxes paid on that income). Unfortunately, things are not that simple. As discussed below, various substantive issues can affect parties' rights and obligations under a tax equalization agreement.[15]

1. Section 911 exclusion.

An employee's federal income tax liability may be reduced under section 911, which excludes from gross income some foreign-source income. If the foreign country's tax rate imposed on the employee is lower than the U.S. federal income tax rate, the employer may benefit under a typical tax equalization agreement from the section 911 exclusion.

Consider the following example: Employee A earns $100 in a foreign country and would pay federal income tax at a 35 percent rate if she worked in the United States. The section 911 exclusion is $10, and the foreign country's tax rate applicable to the employee is 30 percent. Accordingly, A incurs foreign income tax liability of $30, and her U.S. federal income tax liability is

[9] *See* section 904(a).

[10] *See* section 904(c).

[11] Tax treaties may restrict a host country's ability to tax the home country's residents on earnings from short-term employments in the host country.

[12] *See* sections 3101 and 3121(b). A U.S. employer would include a domestic corporation. *See* section 3121(h).

[13] Detailed discussion of these requirements and various nuances and exceptions thereto is beyond the scope of this article.

[14] The employee may also be sophisticated enough to understand, in general terms, FTCs and their function of reducing the U.S. income tax liability.

[15] Also, parties should pay careful attention to how any defined terms or other drafting choices affect their rights and obligations. For example, assume that the equalization payment is determined by reference to the employee's salary and that various allowances are characterized as additions to salary. In that case, the employee may argue that the allowances should not be taken into account when determining the putative U.S. income tax that would have been imposed had the employee remained in the United States.

$31.50 (35 percent of $90, taking into account the section 911 exclusion). Employee A can claim the $30 FTC. If she had remained in the United States, section 911 would not have applied, and A would have paid $35 federal income tax on the $100 of earnings. Under a standard tax equalization agreement, the employee would likely owe the employer $3.50 because her baseline liability would be $35, and her actual tax liability would be $31.50.

Note that the impact of section 911, like so many other things, is not expressly addressed in many tax equalization agreements. Instead, an employer would rely on the (frequently) stated purpose of a tax equalization agreement to insist on the outcome illustrated in the preceding example.

2. State and local taxes.

A tax equalization agreement should be clear about whether it takes into account state and local taxes.[16] In evaluating the potential impact of state and local taxes, the parties should also consider state and local laws regarding residency and credits for taxes paid to foreign countries.[17]

Consider the following example. Employee A is subject to federal income tax at a 35 percent rate, and to state and local tax at a 10 percent rate. A's employer sends her to a foreign country where the tax rate is 40 percent, and where she earns $100. If the tax equalization agreement takes into account state and local taxes, A's baseline tax liability would be $45. Her actual tax liability would depend on whether she remains a resident in her state while working abroad and, if so, whether the state grants FTCs for foreign taxes. Thus, if A does not remain a resident (or remains a resident and can claim an FTC for state income tax purposes), her actual tax liability would be $40 (all paid to the foreign country). In that case, she would owe $5 to her employer. On the other hand, if A remains a resident and can't claim an FTC for state income tax purposes, her actual tax liability would be $50 ($40 paid to the foreign country, and $10 state and local taxes), and her employer would owe her $5.[18] By contrast, if the tax equalization agreement is limited to federal income taxes, A's baseline tax liability would be $35, her actual tax liability would be $40, and the employer would owe her $5.

3. Social Security taxes.

As is the case with state and local taxes, imprecise drafting can create ambiguity regarding whether Social Security taxes are addressed by a tax equalization agreement. Also, as mentioned above, the United States has entered into totalization agreements with several countries to avoid double taxation of income in connection with Social Security taxes.[19] When applicable, a tax equalization agreement should address whether the parties intend for the employee to qualify for benefits under the totalization agreement.

4. Foreign tax credits.

An employee who performs services in a high-tax jurisdiction may end up with excess FTCs that could be used in a different year — for example, when the employee performs services in a low-tax jurisdiction.[20] The parties should consider expressly addressing whether (and, if so, how) the FTCs would affect their respective rights and obligations under a tax equalization agreement.

Consider the following example: Employee A is subject to U.S. federal income tax at a 35 percent rate.[21] In years 1 and 3, A's employer sends her to foreign country X, where the tax rate is 30 percent and where she earns $100. In year 2, A's employer sends her to foreign country Y, where the tax rate is 45 percent and where she also earns $100. In each of the years 1 through 3, A would have paid $35 in federal income taxes if she had earned $100 in the United States.

[16] Imprecise drafting can create ambiguity regarding whether state and local taxes are addressed by a tax equalization agreement. For example, an agreement may address "taxes" but not define the term; or it may refer to "United States federal income taxes" in some places, and just to "taxes" in other places.

[17] For example, New York does not give a credit for taxes paid to foreign countries, except for taxes paid to Canadian provinces. *See* N.Y. Tax Law section 620(a).

[18] Query whether it would be practical for the employer to request that the employee refrain from retaining her residency in the home state while working abroad.

[19] *See supra* text accompanying note 13.

[20] As discussed above, FTCs can be carried back one year and forward for 10 years.

[21] Assume that employee A is not subject to any state and local taxes and does not qualify for section 911 relief.

In year 1, A would claim a $30 FTC for taxes paid to foreign country X and pay $5 in federal income taxes. In year 2, A would be subject to tentative federal income tax of $35 and claim a $35 FTC for taxes paid to foreign country Y. Further, A would carry back to year 1 a $5 FTC for taxes paid to foreign country Y and claim a refund for the $5 federal income tax paid in year 1. A would also have a $5 FTC that would be carried forward. In year 3, A would claim a $30 FTC for taxes paid to foreign country X, and a $5 FTC for taxes paid in year 2 to foreign country Y. Thus, over the three-year period, A's actual tax liability would be $105, the same as her baseline liability.

If the tax equalization agreement does not take into account the FTC, the employer would owe A $10 in year 2, and A would not owe the employer anything in years 1 and 3. In that case, A would arguably receive a $10 windfall over the three-year period. Alternatively, if the tax equalization agreement takes into account actual use of FTCs, in year 2 the employer would owe A $5, and in year 3 A would owe the employer $5.[22] Finally, if the tax equalization agreement treats the employee as benefitting from all FTCs, regardless of whether she can use them, neither A nor the employer would be required to make any tax equalization payments.[23] In that case, A would bear the risk that she could not use the FTCs in the future.

5. Gross-up.

Any tax equalization payment from an employer to an employee would generally constitute ordinary income to the employee. Should a tax equalization agreement require that any payment be grossed up to take into account any additional tax burden imposed as a result of the payment? That would depend on several factors, including whether the gross-up is calculated by reference to the employee's baseline liability.

Consider the following example: Employee A is subject to federal income tax at a rate of 35 percent. A earns $100 while working in a foreign country, and pays $45 foreign tax. A's baseline tax liability is $35. If the employer pays A $10, A's taxable income would increase to $110, and her federal tax liability would be $38.50. Assume that A can claim the full $10 FTC to satisfy the federal income tax owed on the gross-up payment.[24] In that case, if the gross-up clause simply requires the employer to gross up the payment by A's domestic tax rate, the employer would owe A $3.50. By contrast, if the gross-up is required only to the extent that A's actual tax liability, taking into account taxes paid on the equalization payment, exceeds A's baseline tax liability, the employer could maintain that no gross-up is required.

B. Procedural Issues

Calculation of equalization payments and dispute resolution should be expressly addressed in a tax equalization agreement. The former would presumably be performed by the same accounting firm engaged by the employer to provide tax return preparation services for employees on foreign assignments.[25] The latter is not always addressed in equalization agreements, but it should be. If a tax equalization agreement does not expressly address dispute resolution, disputes would presumably be resolved in court, unless the agreement incorporates other terms of the employee's employment that provide for arbitration.

[22] At the end of year 1, A's actual tax liability would be the same as her baseline tax liability, and she would have no excess FTCs. At the end of year 2, A's actual tax liability for year 2 would be $10 higher than her baseline, but she could also use $5 of the FTC to claim a refund for year 1. At the end of year 3, A's actual tax liability for year 3 would be $5 lower than her baseline, taking into account the remaining $5 FTC from year 2.

[23] At the end of year 1, A's actual tax liability would be the same as her baseline tax liability, and she would have no excess FTCs. At the end of year 2, A's actual tax liability for year 2 would be $10 higher than her baseline, but she would also have a $10 FTC that would be treated as benefitting A. At the end of year 3, A's actual tax liability for year 3 would be the same as the baseline tax liability.

[24] When computing the section 904 limit on the employee's FTCs, it would be important to consider whether the tax equalization payment itself is foreign source. *Cf.* Rev. Rul. 83-177, 1983-2 C.B. 112. It would also be important to consider whether the tax equalization payment is subject to tax in the country where the services are performed.

[25] One pitfall for employees is that the calculation could in all likelihood be made by a party that has a much stronger business relationship with the employer than with the employee. In theory, an employee would be free to question the calculation prepared by the accounting firm. In practice, the employee would either have to be proficient in understanding tax returns or spend a significant amount of money to engage a professional to double-check the calculation. These are high hurdles to clear, especially if the employee does not adequately appreciate the many ambiguities that could be present in a tax equalization agreement.

IV. Dispute Considerations

If employers or employees believe they are entitled to a payment under a tax equalization agreement, they should consider the costs and benefits of pursuing their claim. Attorney costs are likely to be somewhat high for both parties, relative to the amount at stake.[26] An employee would have additional adviser costs if she wants to engage an accountant to verify the amounts computed by the return preparer who was engaged by the employer.[27] An employer, on the other hand, could risk lowering employee morale if its employees learn that it pursues claims under tax equalization agreements.

The foregoing costs may be reduced by mandating arbitration. However, the issues arising under a tax equalization agreement are likely to be unfamiliar to advisers and arbitrators who generally focus on labor and employment issues. Regardless of the venue, parties should consider engaging both a tax specialist and a labor and employment specialist. It would not be surprising if the costs of litigation are disproportionately high relative to the amount in dispute. In those cases, advisers may well remember the legal adage that lawyers learn during the first year of law school: Possession is nine-tenths of the law. ■

[26] Although employees would generally be more sensitive to attorney costs because they would be paying out of pocket, employers typically establish guidelines and budget for outside counsel costs.

[27] Employees would generally bear any accountant costs out of pocket. However, it may be unnecessary for the employee to engage an accountant if a dispute is about the interpretation of the tax equalization agreement, *e.g.*, whether FTCs are taken into account, and the employee accepts the original computations prepared by accountants engaged by the employer.