

What Is Tax Equalisation?

One topic that regularly arises when dealing with international assignees is the subject of tax equalisation. This often creates confusion and questions for many assignees and those in Human Resources. Given this I thought it would be useful to provide an overview of the principles of tax equalisation: what it is, how it works and some alternative approaches.

Why Is Tax A Factor?

Tax equalisation aims to remove tax as a relevant factor in the international assignment decision process. Without tax equalisation, tax is a factor as tax rates differ from country to country. For example, there will be no tax in Saudi Arabia whereas in Denmark the rate can be nearly 60%.

If companies play no active part in the tax process, individuals often look at their net pay in deciding whether to take up or return from an international assignment. Continuing with our examples, an individual sent to Saudi Arabia has significantly greater net pay than the individual being sent to Denmark, even though they may do the same job. This of course, assumes there is no continuing tax liability in the home country, which may not be the case for US individuals.

It should be remembered that removing tax from the decision making process does not mean removing tax as a cost. This remains and may increase with tax equalisation. However, in some scenarios tax equalisation could result in funds being received by the employer from the employee.

What Is Tax Equalisation?

Tax equalisation aims to ensure the individual is no better or worse off as a result of taxes whilst on an international assignment. If the tax burden is higher than it would have been in the home country then the company pays the excess, whereas if it is lower then the company takes the savings.

Tax equalisation means that for the individual their net pay remains certain. The individual knows what they will receive and from a tax perspective it makes no difference to them whether they are in Saudi Arabia or Denmark. As a consequence there should be less

issues arising over both the timing of assignments and compensation packages.

How Does It Work In Principle?

The principle objective is that the individual is 'no better or worse off' as result of taxes. The steps in determining tax equalisation are as follows:

- Determine what the tax liability on 'standard pay' would have been had the individual remained in the home country. *The resulting figure will be the individual's hypothetical tax liability*
- Deduct the hypothetical tax liability from the individual's 'standard pay'
- Add in any allowances to be paid as a result of the assignment. *The resulting figure will be the individual's net assignment pay*
- Calculate the host country tax due on the net assignment pay. *The resulting figure is tax equalisation.*

What Are The Potential Complications?

The above steps appear to be relatively straightforward but complications may arise.

Calculating an individual's tax liability on 'standard pay' as if they had remained in the home country may appear easy. However, you need to consider what income and benefits to include and on what basis to file. For example, if an individual normally pays pension contributions and also has a company car but will not have either whilst on assignment, do you include these in determining hypothetical taxes?

The important thing to remember is that hypothetical taxes are exactly that, hypothetical. They do not represent real taxes payable to a revenue authority. Therefore, when determining an individual's home country taxes you can use whatever basis you want and agree with the individual. The key is that all parties must know on what basis the hypothetical tax is calculated and that principles of fairness and equity apply to the calculation. As parties' memories can be selective and there are no 'jobs for life' it is imperative that the basis of the agreement is set out clearly. A tax equalisation policy is extremely useful for documenting the guiding principles that apply, and both the specific mechanics and application of the calculation.

Other issues to consider as part of any policy include the following:

- How is spousal/civil partner's income treated?
- How is investment income and capital gains treated?
- Who benefits from split-year tax treatment?
- What happens when share options are exercised or restrictions are lifted?
- If the individual leaves and joins another company, which does not have tax equalisation, how do you prepare the calculation?
- Do you discourage individuals from acquiring property in the host country?
- What's the logic behind the deduction of home country taxes if the individual does not have a continuing home country liability or is going to a country with a nil tax rate?
- Who owns the tax credits that may arise from the payment of foreign taxes?
- How much does a company want to get involved with an individual's personal financial affairs?

In summary, the more issues you consider beforehand, the easier it is to deal with them when they arise at a later date. Also, do remember to review policies regularly as deductions and issues change and the policy can get out of date.

How Does It Work In Practice?

Once the hypothetical tax liability has been determined this amount is deducted from the individual's pay and represents a contribution to the individual's tax liability and a reduction in their net pay. This amount is deducted on a regular basis throughout the assignment.

A company can either try to work out the appropriate hypothetical tax at every relevant stage during the year for example, on each pay rise, or more usually a company can determine an approximate hypothetical liability at the outset of the year and undertake a tax reconciliation at the year-end. Most companies tend to adopt the latter approach. Where they do, the reconciliation will determine whether too much or too little hypothetical tax has been deducted, and whether a payment is required to or from the assignee to the company. Do remember that additional hypothetical tax will reduce the current net pay further. Additionally, any

hypothetical tax reimbursement may represent extra taxable income.

What About Real Taxes?

As part of the tax equalisation process the individual's obligation is to pay hypothetical tax to the company. The company's obligation to the individual is to pay both home and host country actual tax liabilities relating to the assignment. A continuing home country liability may or may not be relevant depending on factors such as domestic legislation, the length of the assignment and continuing ties to the country. If it is relevant the company pays any home country tax due for the assignment period.

In the host country the company pays taxes that arise on all taxable income including assignment related allowances and payments. The assignee does still, of course, need to comply with individual filing requirements and legally the tax liability generally remains the responsibility of the individual.

Managing Reputational Risk

Payment of an assignee's salary in multiple currencies and multiple countries gives rise to the potential for an assignee that is left to their own devices, to file a return somewhat different to the correct position, either through tax evasion or aggressive tax avoidance schemes. Without tax equalisation such a stance can improve the individual's net pay. Either approach exposes the company to financial and reputational risk. After all, the company is usually the static entity in the assignment process whereas individuals come and go both between countries and employments.

One advantage of tax equalisation is that by assuming responsibility for all real taxes the company assists in the tax return process, thus helping to ensure the individual files and files correctly. The company's reputation and good standing should therefore be preserved.

Tax Planning

Tax planning still has a major role to play in determining the structuring of the assignment package and in minimising the tax liability in the host country. Proper planning may well reduce the tax liability payable by the company. Companies should therefore look to see for example, whether benefits or cash should be provided, whether payment should be made by the home or host

entity and whether expatriate allowances are available.

It should be remembered that as the company is paying the individual's tax on their behalf, this might itself be a taxable benefit. For example, if an individual's net pay is 60 and the tax rate is 40% the gross pay becomes 100 and the tax 40 (not 24). This is the 'gross-up calculation', where tax becomes payable on tax. Using planning to reduce the tax liability has a far greater impact where tax equalisation applies, as there is less to gross up. It is acknowledged that variations on a straightforward gross up calculation can and do apply in different countries.

The cost of tax equalisation can also lead to a variation in the nature of assignments with a trend towards short-term and commuter assignments and extended 'business trips'. This needs to be monitored as tax authorities around the world are increasingly focussing on short-term business visitors.

Alternatives To Tax Equalisation

Tax equalisation arguably arose as a result of US multinationals sending US nationals on assignment where the individuals had a continuing liability to US tax. The European model tended to be one of tax protection as more often there was no continuing liability to tax in the home country whilst the individual was on assignment.

Tax Protection

The principle concerning tax protection is that the employee cannot be worse off from a tax perspective as a result of their assignment. It differs from tax equalisation as under tax protection an individual can be better off and obtain a tax windfall if host country taxes are lower than they would have been without the assignment.

The principle advantages of tax protection are that it can be cheaper for the employer as there may be no gross-up and the individual can be better off. However, disadvantages can arise, as until the year-end it is not known what the comparative liabilities are until the returns are filed, taxes paid and a reconciliation undertaken. Without advances or loans to pay taxes there can be a negative cash flow for the individual. Additionally, as mentioned above if the individual files their own taxes and they get any tax windfall it may encourage differing attitudes towards tax reduction, including

restructuring performance of their job to their own fiscal advantage or simply failing to report income.

Ad Hoc Policy

Some companies decide a formal policy is inappropriate and simply deal with each situation on a case by case basis. A major drawback to this approach is that each individual seeks to negotiate a better, increased, package. Whilst an ad hoc approach may work for very small expatriate populations, as soon as numbers increase, so do the problems caused by the lack of a coherent policy.

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On your own! In such cases the employer plays no role in the individual's tax process and simply pays the individual their gross salary. The individual then files their own tax returns, or not, without company assistance. A number of companies prefer this approach, as it is simpler and cheaper from a compliance perspective to administer. Drawbacks remain as, for example, both tax planning and actual compliance with tax legislation may not occur.

Naturally there are many additional issues associated with tax equalisation, which cannot be covered within this article. Many of the issues are not tax centred but focus on a company's philosophy towards its international assignee population.

Whilst tax equalisation has attracted criticism in recent years, notwithstanding this, for the global employer wanting international mobility and fairness and equity for its international assignees, tax equalisation has many advantages and will remain with us for the foreseeable future.



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