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Year-End Payroll Tax Withholding Exposure

As the 2020 calendar year-end approaches, and much of the world continues to practice some form of sheltering in place, social distancing and working remotely, companies should again assess their payroll tax reporting and withholding obligations across the U.S. and the globe. Many states have offered relief from withholding tax on employees working from home temporarily…but the key word is "temporarily." How is that defined? Who would have expected that six months later, employees would still be working from their kitchen tables or desks at home?

We at BDO continue to monitor the tax landscape and identify unanticipated compliance risks for companies with remote or displaced employees, and we urge you to consider the following potential exposures:

STATE TAX RESIDENCY AND WITHHOLDING

Employees who were used to crossing state borders to go to work every day and having state tax withheld and remitted to that work state may be in for a surprise for 2020. Depending on reciprocity agreements, an employee's resident state may now require tax withholding because the work is physically being performed at home. In these cases, the employer has the obligation to change the state for which the tax is withheld. But be careful: Some states have indicated that even if the employee is no longer commuting over the border to work in their state, if the employee would have been commuting to their state but for the COVID-19 restrictions, the former work state will continue to assess and collect withholding tax, causing duplicate tax obligations.

On the international front, U.S. outbound expats sheltering in place in the U.S., in some cases for more than six months, may create a tax residency issue in the state where their home is located. This may require their employer to turn on actual state tax withholding or address a potential underfunding of state tax withholdings from previous pay periods. Foreign nationals who were on a U.S. assignment and returned to their home country to shelter in place may not meet the state residency requirements. In this case, if the individual is on U.S. payroll, federal and state tax withholding should be reviewed to determine if the withholding needs to be adjusted or stopped until the individual returns to the U.S.

NEXUS AND PERMANENT ESTABLISHMENT RISK

In the cases discussed above where an employee is now working remotely from a state in which their employer previously had no business presence, the possibility of corporate nexus and exposure to corporate income tax due to that state must not be overlooked. There are many criteria that could contribute to tax nexus in a state, and one of them is the presence of an employee and the specific duties the employee performs.

At the international level, when the initial reporting on the coronavirus broke, several expats were relocated to a neighboring country or another country in the region instead of their home country, with the expectation that the relocation would be for a short time period. This allowed the expat to continue to work from the same region, however, this too can create the potential for corporate tax exposure in the country the employee relocated to, especially when that short time period now exceeds six months. We recommend that employers review such expats' job responsibilities and assess the exposure with your corporate tax department.

FOREIGN COUNTRY TAX OBLIGATIONS AND TREATY RELIEF

Many expats are currently quarantined in their host countries and are unable to repatriate back to their home country or even a neighboring country due to travel restrictions. These travel restrictions could lead to short term expatriates exceeding the 183-day threshold prevalent in many income tax treaties, which could give rise to unexpected tax residency and income taxation in the host country. Employers should closely monitor the actual and anticipated day counts in the host country and identify any employees that are close to exceeding the 183-day threshold.

EXPATRIATE SPECIFIC TAX WITHHOLDING ISSUES

- **Shadow Payroll Reporting:** Companies are repatriating their expats temporarily to address challenges in the host jurisdiction as a result of the coronavirus. In doing so, this may have an impact on the shadow payroll reporting in the host jurisdiction. Employers may need to review the shadow payroll calculations and modify the level of income reported and income and social tax withholdings to account for the absence from the host jurisdiction.
- **Hypothetical Tax Withholding:** If an expat is repatriated temporarily to his or her home country, is tax equalized and the company is deducting a hypothetical tax, it may be prudent to suspend his or her hypothetical tax withholding and switch back to actual income tax (and potentially social tax) withholding.
- **Foreign Earned Income Exclusion:** If a temporary repatriation jeopardizes a U.S. outbound expat's ability to meet the bona fide residence or physical presence tests to qualify for the foreign earned income exclusion, the foreign tax credit is usually a viable fallback position to minimize potential double taxation, provided taxes are being paid in the host country. For U.S. state tax purposes, if the state does not allow a credit for foreign taxes paid, there could be an unexpected increase in actual state tax costs.
- **Foreign National U.S. Residency Test:** If a temporary repatriation to the individual's home country causes the individual and/or family members to fail to meet U.S. the residency test, the U.S. and state tax withholding will need to be reviewed to determine if adjustments are needed. Communicating expectations with the employee regarding refunds or tax balances owed will be important, along with identifying which party, company or employee, owns the refund or is responsible for additional tax payments. Review of the individual's home country residency and tax withholding requirements should also be assessed.

BDO can assist in assessing the exposures discussed above and mitigate exposure to employment tax penalties that may be looming.