
United States: Report prompts IRS to verify claims of exemption from social security taxes under totalization agreements

October 5, 2015

In brief

A report by the Treasury Inspector General for Tax Administration (TIGTA) dated July 17, 2015 regarding US social security and Medicare taxes (hereinafter FICA) may impact globally mobile individuals and their employers. The report concludes that the Internal Revenue Service (IRS) cannot readily identify US citizens, resident aliens working in a foreign country, or resident aliens working in the United States, who have improperly claimed exemption from FICA under a totalization agreement.

A main concern raised by the TIGTA is that while the Social Security Administration (SSA) receives certificates of coverage from foreign countries, the IRS has no way to obtain these certificates to identify noncompliance. Nor does the IRS know whether foreign social security taxes have in fact been paid. As a result, the report recommends that the IRS coordinate with the SSA to acquire this data.

The IRS generally agreed with the report recommendations and plans to implement them. In the meantime, the IRS could start seeking certificates of coverage or evidence of payment of foreign social security taxes directly from the mobile individual or his/her employer. The IRS has rarely sought such documentation in the past.

In detail

Background

Totalization agreements aim to eliminate double taxation

Generally, individuals working across borders and their employers could be required to pay into both countries' social security systems on the same earnings. However, the United States has entered into 25 international agreements

(totalization agreements) in an effort to eliminate this potential double taxation. Coverage under a totalization agreement can help eliminate US FICA liabilities if certain requirements are met.

In general, US totalization agreements provide that social security coverage will be restricted to the country where work is performed (with certain exceptions, for example self-

employed individuals' coverage is typically restricted to the country of residence).

Exceptions can apply, for example under so-called 'detached worker' rules which restrict coverage, to the home country, for individuals sent from one agreement country to another, to work in the other for the 'home country' employer

for a period of five years or less.

Under this exception, where the 'home country' is the US, the individual must work for an 'American employer' during the detached period or for a subsidiary entity where the American employer has elected to cover the subsidiary's US citizen and resident employees for FICA purposes. Note that agreements allow for exceptions to the general rule and the detached worker rules in unique circumstances, upon request.

Substantiation of FICA exemption

Employers (including self-employed individuals) request certificates of coverage under the detached worker rule from the country from which the individual is being sent. The certificates should be kept by the employer to establish exemption from 'host country' social tax during the certificate period. Historically, the IRS has rarely asked individuals or their employers for copies of foreign certificates of coverage/proof of exemption under a totalization agreement.

TIGTA report prompts IRS action

Implementation actions agreed upon by the IRS

As part of the report, the IRS responded by agreeing to certain corrective actions to address the issue of potential missed revenue due to improper reliance on totalization agreements. The IRS agreed to work with the SSA to:

- Establish a process to periodically acquire copies of certificates issued by foreign authorities that were received by the SSA under totalization agreements.

Currently, the SSA receives copies of certificates issued by foreign jurisdictions, however, the SSA

only uses this information to record the number of certificates approved. The SSA then destroys the information. The IRS does not have a procedure to obtain any data relating to these certificates from the SSA.

- Obtain data from totalization agreement countries with respect to foreign social security taxes paid. Currently there is no systematic exchange of information between countries in this regard.

In the report, the IRS indicates that it will perform the above actions by March 30, 2016. Additionally, the IRS agrees to explore the use of data collected to identify noncompliance by March 31, 2017.

Estimate of potentially missed revenue

A rough estimate of the revenue which may be lost due to improper claims of exemption under totalization agreements is included in the report. The estimate is \$16.9 million for 2012 (1,427 individual taxpayers) and \$84.4 million when the estimate was broadened to over 5 years (7,135 individual taxpayers.) While the IRS disagreed with these estimates, it did not say whether they were too low or too high.

The takeaway

More details to unfold

Other than the corrective actions noted above, no further details have been provided as to how the IRS will respond to this report. Most notably, it is unclear how the IRS will make changes to their current audit procedures – both before and after the SSA data gathering processes are put into place.

The IRS could soon start seeking copies of foreign certificates of coverage. Additionally, the IRS may start requesting documentary evidence that foreign social security was actually paid, as the certificates do not provide such information.

It is unclear in what situations the IRS may ask for these certificates. For example, will the IRS request certificates for *any* Form W-2 issued with federal wages but not FICA wages/tax or will they be more selective? Will the IRS seek certificates from employees on short term assignments as well as long-term, and from those filing Forms 1040NR in addition to those filing Forms 1040? Specific agreement rules will presumably be taken into account. As an example, the Canadian totalization agreement specifically indicates that no certificate of coverage is required for assignments/trips below 183 days.

In addition, how will the IRS address compensation not subject to FICA but not on account of the detached worker provisions of a totalization agreement? For example, will the IRS seek other verification for those receiving Forms W-2 but not subject to FICA under domestic law, e.g., those that are working outside the US for a foreign common law employer (but who may receive a W-2 from a US entity as a payroll agent), in agreement and non-agreement countries alike?

Other potential IRS actions

The IRS may wish to publish a Field Service Advice about this potential revenue 'opportunity', which could provide employers better insight as to how they will proceed. They may also issue a standard IDR (information document request) that includes specific questions regarding FICA exemption. Presumably these would be issued during a payroll audit

(versus directly to the individual) except perhaps for self-employed individuals not paying self-employment tax.

Preparatory actions by employers

The report is focused on noncompliant employers who are improperly avoiding the payment of

FICA under the guise of totalization agreements. Employers should consider processes to specifically confirm/check FICA compliance both for expats out of and in-pats into the United States.

Moreover, employers should be prepared to provide substantiation quickly. US payroll managers should

consider keeping copies of foreign certificates of coverage on file (or readily available from the foreign employers who obtained them), as payroll audits typically require documentation to be provided within a fairly tight time frame. Documentation of other reasons why FICA may not technically apply should also be kept.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your Global Mobility Services engagement team or one of the following team members:

Global Mobility Services – United States

Peter Clarke, *Global Leader*
+1 (203) 539-3826
peter.clarke@pwc.com

Al Giardina
+1 203 539-4051
alfred.giardina@pwc.com

Derek Nash
+1 202 414-1702
derek.m.nash@pwc.com

Clarissa Cole
+1 213 217-3164
clarissa.cole@pwc.com

Evelyn Behrend
+1 267 330-6220
evelyn.behrend@pwc.com

Stay current and connected. Our timely news insights, periodicals, thought leadership, and webcasts help you anticipate and adapt in today's evolving business environment. Subscribe or manage your subscriptions at:

pwc.com/us/subscriptions

SOLICITATION

© 2015 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com.