Publications

IRS Counsel Memorandum Analyzes FICA and Income Tax Withholding Rules for Certain Employees Working Abroad

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A recent Internal Revenue Service ("IRS") memorandum explains that U.S. employers and their payroll departments should carefully consider the withholding obligations for employees working abroad. On July 7, 2023, the IRS released Chief Counsel Advice Memorandum 202327014 (the "Memorandum"), which discusses a U.S. company's withholding obligation with respect to Federal Income Tax Withholding ("FITW") and Federal Insurance Contributions Act ("FICA") taxes on restricted stock unit ("RSU") compensation for employees who performed services related to such compensation partly in the U.S. for a U.S. company, and partly in a foreign country for its foreign subsidiary. The IRS concluded that the portion of the RSU income from services performed in the foreign country were considered wages for FITW purposes, but not for FICA purposes. Accordingly, the employer had a FITW withholding obligation for *all* the RSU income, but a FICA withholding obligation only for the wages attributable to the services performed in the U.S. As explained below, the IRS analysis hinged on the definition of wages for FICA purposes and FITW purposes.

We note that a Chief Counsel Advice Memorandum is prepared for the internal use of IRS agents and attorneys and may not be relied upon as precedent. However, it provides useful analysis on possible IRS positions, particularly where official guidance is not available.

RSU Income

An RSU generally is a promise to pay an employee shares of company stock (or the cash equivalent value) at a future date, subject to a vesting schedule and sometimes performance goals. RSUs are intended to motivate employees by tying their performance to the success of their employer over a long-term period (typically several years), usually referred to as a vesting period.

Under the facts in the Memorandum, the employees were U.S. citizens or residents who were employed by a U.S. company and worked in the U.S. The employees were granted RSUs by the U.S. company with a specified vesting period. Prior to the end of the vesting period, the employees were transferred to a foreign country to serve as employees of the U.S. company's foreign subsidiary. While in the foreign country, the employees worked under the direction and control of the foreign subsidiary, not the U.S. company. Thus, a portion of each employee's services attributable to the RSU income was performed for a U.S. employer in the U.S, and a portion was performed for a foreign employer in a foreign country. Notably, the U.S. company, not the foreign subsidiary, paid the RSUs.

FITW and FICA Wages

The key to the different results regarding the U.S. company's withholding obligation with respect to the RSU income is the definition of "wages," which is different for FITW and FICA purposes. For FITW purposes, Internal Revenue Code ("Code") section 3401(a) and the regulations thereunder provide that renumeration for personal services performed by a U.S. citizen or resident includes wages earned while working for a foreign entity. Further, Code section 3401(d)(2) provides that where a U.S. entity pays wages on behalf of a foreign entity that is not engaged in a trade or business in the U.S., the U.S. entity is the "employer" for FITW purposes. Accordingly, because the U.S. company paid the RSUs on behalf of the foreign subsidiary, the IRS concluded that the U.S. company would have a FITW obligation with respect to *all* the RSU income, including the income attributable to services performed by employees abroad.

In contrast, for FICA purposes, under Code sections 3121(a) and (b), the term "wages" generally excludes amounts paid for services performed for a non-U.S. employer. The IRS concluded that because FICA wages do not include amounts attributable to services performed for the foreign subsidiary, the U.S. company must only withhold FICA on the portion of RSU income attributable to *services performed in the U.S.*

The IRS noted that, under Code sections 861 and 862 and the associated regulations, the U.S. company should use a reasonable allocation method to determine the amount of FICA withholding due. The IRS indicates an "appropriate allocation" can be based on measuring the amount of RSU income in proportion to the total number of days of work performed, and allocating the income earned in the U.S. (and thus subject to FICA) based on the number of days the employees worked in the U.S. compared to the number of days worked in the foreign jurisdiction.

Totalization Agreement and Tax Treaty Considerations

The IRS noted in the Memorandum that there was no "totalization agreement" in place between the U.S. and the foreign jurisdiction in question. Generally, if the U.S. and a foreign jurisdiction both impose taxes for Social Security as well as comparable foreign social insurance programs on the same wages, the U.S. and the foreign jurisdiction may enter into a "totalization agreement" to prevent double taxation. The IRS suggested that even the portion of FICA wages earned by the employee in the U.S. could avoid U.S. FICA tax if a totalization agreement with the foreign jurisdiction provided that such portion is subject solely to the foreign jurisdiction's social insurance system.

In addition, the IRS noted that no tax treaty existed between the U.S. and the foreign jurisdiction. The IRS cautioned that the Memorandum does not address the impact of a worker's transfer to a foreign jurisdiction that has a tax treaty in place with the U.S., or how such a treaty might impact the FITW obligations.

Conclusion

U.S. companies should aim to work closely with their payroll departments when their employees are transferred to a foreign subsidiary. The Memorandum provides helpful insight for companies in determining their FICA and FITW obligations for employees who work for foreign subsidiaries in jurisdictions without a tax treaty or totalization agreement. However, if the employees are in a treaty jurisdiction or a jurisdiction that has a totalization agreement with the U.S., the terms of the applicable treaty or agreement should be carefully reviewed to determine if different rules apply.