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Memorandum

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subject: Income Tax Refund to Employer in a Subsequent Year Following the Use of Tax Equalization Methods

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether an employer is eligible to receive a refund of income tax withholding paid on behalf of an employee on a foreign assignment in a year after the calendar year in which the employer paid remuneration to which the income taxes are attributable in a situation where the employer uses a tax equalization program to adjust the employee's pay so that the employee will have no net economic gain or loss with respect to tax liability because of the foreign assignment, and pays the income tax withholding attributable to the employee's adjusted pay.

CONCLUSION

When an employer pays an employee on a foreign assignment a stated amount of remuneration that is subject to income tax withholding under § 3402, and pays the income tax withholding attributable to the remuneration on behalf of the employee, then the income taxes the employer pays to the Internal Revenue Service (Service) are considered withheld from the employee and thus may not be refunded to the employer after the calendar year in which the wages were paid.

BACKGROUND

Companies with an international presence often station employees in countries other than the employee's country of citizenship. When doing so, these companies frequently offer tax equalization programs to employees on international assignments. Tax equalization is a process that is intended to result in the employee having no economic gain or loss with respect to tax liability because of the foreign assignment. After all expected taxes are considered, an employee may be better or worse off economically because of the foreign assignment if an adjustment to salary is not made. The tax equalization program is designed to result in the employee paying approximately the same amount of income tax as the employee would have paid if he or she had not been placed on an international assignment.

Under the tax equalization process, a company will enter into a tax equalization agreement with its employee prior to stationing the employee in a new country. As part of the tax equalization agreement, the company and the employee will calculate what is commonly referred to as a "hypothetical tax." The hypothetical tax calculation made before the beginning of the tax year constitutes an approximation of what the employee's overall tax liability would be for the upcoming year if that employee were to remain in the United States (approximate hypothetical tax). The employee's previously agreed upon salary for the upcoming year is reduced by the amount of this approximate hypothetical tax, and the employee is not entitled to receive that portion of the employee's prior salary. The company will usually pay all taxes owed on remuneration the employee receives from that company on behalf of the employee for both the country where the employee is stationed (host country) as well as the employee's country of citizenship.

The company will generally file quarterly Forms 941 and remit income tax withholding consistent with the quarterly filings. The company will also show the income tax withholding amounts remitted to the Service as income tax withheld from the employee's wages on the Form W-2 it files and furnishes to the employee after the end of the calendar year.

After the end of the calendar year, the company and the employee calculate the exact amount of taxes that the employee would have owed had the employee remained in the United States as the "actual hypothetical tax." Upon making the new calculation, the company and the employee adjust payments to make up the difference between the actual hypothetical tax and the approximate hypothetical tax computed before the beginning of the year. If the approximate hypothetical tax was too high, the company pays the employee the difference between the actual hypothetical tax amount (generally calculated by a third-party accounting firm) and the approximate hypothetical tax amount that was deducted from the previously agreed upon salary. The company usually pays any additional taxes on this additional income. If the approximate hypothetical tax is too low, however, the employee is generally required to repay a

portion of the employee's remuneration paid in the prior year back to the company. The issue presented is whether a United States company that pays United States income tax withholding in excess of what should have been withheld is entitled to claim a refund of the excess withholding in a year subsequent to the calendar year in which the remuneration that gave rise to the United States tax liability was paid to the employee.

FACT SITUATION:

A United States company sends a United States citizen employee on international assignment and pays the employee remuneration subject to income tax withholding under § 3402. Under the company's tax equalization program, the company agrees in advance of the international assignment to pay the employee a stated amount of remuneration, net of any taxes owed on the remuneration, which is intended to equal the after-tax remuneration the employee would receive if they had remained in the United States instead of accepting a foreign assignment. The United States company reduces that employee's salary by the approximate hypothetical tax and pays the required income tax withholding throughout the year in which remuneration is paid to the employee.

LAW

Employers are generally required to deduct and withhold federal income tax from wages paid to their employees under § 3402(a). Section 31.3403-1 of the Treasury regulations establishes that an employer is liable for the withholding and payment of employment taxes, whether or not amounts are actually withheld.

The term "wages" for purposes of income tax withholding is defined in § 3401(a) as all remuneration for services performed by an employee for his employer. Section 3402(p)(3) provides that the employer and the employee can agree that the employer will withhold taxes from payments for services that do not constitute "wages." If the employer and employee agree to the voluntary withholding, then any payments with respect to which the agreement is made shall be treated as if they were wages paid by an employer to an employee.

Section 31.3401(a)-1(b)(6) of the Treasury regulations provides that the term "wages" includes the amount paid by an employer on behalf of an employee (without deduction from the remuneration of, or other reimbursement from, the employee) on account of any payment required from an employee under a State unemployment compensation law, or on account of any tax imposed upon the employee by any taxing authority, including the taxes imposed by §§ 3101 and 3201.

Rev. Rul. 78-374, 1974-2 C.B. 67, provides that a 'staff assessment' withheld from the salary of a U.S. citizen employed by the International Civil Aviation Organization that is neither available to, or received by, the employee nor part of a deferred compensation,

pension, or disability plan is not includible in the employee's gross income. Sections 6402, 6413 and 6414 permit interest-free adjustments and claims for refund to correct overpayment errors related to income tax withholding. Section 6402 establishes the procedures for filing claims for refund. Section 6402(a) provides, in part, that in the case of any overpayment, the Secretary may credit the amount of such overpayment against any tax liability of the person who made the overpayment and shall refund the balance to such person.

Section 6413(a)(1) generally provides for interest-free adjustments in such manner and at such times as the Secretary prescribes by regulation if more than the correct amount of tax imposed by §§ 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of remuneration.

Section 6413(b) generally provides for a refund if an overpayment cannot be adjusted under § 6413(a) in such manner and at such times as the Secretary prescribes by regulation if more than the correct amount of tax imposed by §§ 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of remuneration.

Section 6414 provides that in the case of an overpayment of income tax withholding, a refund or credit shall be made to the employer or to the withholding agent only to the extent that the amount of such overpayment was not deducted and withheld by the employer or withholding agent.

Section 31.6413(a)-2 generally provides procedures for the interest-free adjustments of overpayments of income tax withheld from wages. Section 31.6413(a)-2(c)(2) provides that if an employer files a return for a return period on which income tax required to be withheld from wages is required to be reported and reports on the return more than the correct amount of income tax required to be withheld, and if the employer ascertains the error after filing the return, and repays or reimburses the employee in the amount of the overcollection as provided in § 31.6413(a)–1(b)(2), the employer may correct the error through an interest-free adjustment.

Section 31.6413(a)-1(b)(2) provides that if the employer ascertains the error after filing the return but before the end of the calendar year in which the wages were paid, the employer shall repay or reimburse the employee in the amount of the overcollection prior to the end of the calendar year.

An interest-free adjustment for an overcollection of income tax withholding can only be made if the employer discovers the error and repays or reimburses the employee within the same calendar year as the payment of the wages. However, under § 31.6413(a)-2(c)(2), an employer can correct an overpayment of income tax withholding due to an administrative error even if the employer did not discover the error until after the employer filed the return and did not repay the employee within the calendar year.

An administrative error involves the inaccurate reporting of the amount withheld due to a

transposition error or math error. In other words, an administrative error occurs when the amount the employer reported as withheld on the employer's employment tax return does not agree with the amount actually withheld from the employee's wages. An employer can't make an interest-free adjustment to correct income tax withholding for prior years for non-administrative errors. Thus, an employer can't correct income tax actually withheld in a prior year if the employer discovers that the correct amount was not withheld, because the failure to withhold the correct amount of income tax is not an administrative error.

Section 31.6402(a)-1 refers to §§ 31.6402(a)–2, 31.6402(a)–3, and 31.6414–1 for regulations under § 6402 of special application to credits or refunds of employment taxes. Section 31.6414-1 provides rules under which a claim for credit or refund of an overpayment of income tax withholding may be made. While § 6402 provides a process for refund of an overpayment of income tax withholding as noted above, § 31.6414-1(a) provides that no refund to the employer will be allowed for the amount of any overpayment of tax which the employer deducted or withheld from an employee. Situation 2 of Rev. Rul. 2009-39, 2009-52 I.R.B. 951 illustrates the application of the interest-free adjustment and claim for refund processes as it relates to the overpayment of income tax withholding.

In Old Colony Trust Company v. Commissioner, 279 U.S. 716 (1929), the Supreme Court considered whether the payment of income taxes payable on an employee's salary by his employer pursuant to a contractual agreement constitutes additional taxable income to the employee. The Court held that the payment of the taxes was made in consideration of services rendered by the employee and was includible in the employee's gross income. The Court stated that it is immaterial that employer paid the taxes directly to the Government. The discharge by a third person of an obligation owed by the taxpayer is equivalent to the receipt of the amount of discharge by such taxpayer.

Rev. Rul. 58-113, 1948-1 C.B. 362, provides that the term "wages" includes the amount paid by an employer on behalf of an employee (without deduction from the remuneration of, or other reimbursement from, the employee) on account of any tax imposed upon the employee. See also § 31.3401(a)-1(b)(6). Thus, an employer that wishes to pay an employee a stated amount of take-home pay as a bonus and, to pay on the employee's behalf, the income tax required to be withheld under § 3402 must include in the employee's income and wages both the stated amount of take-home pay and the income tax required to be withheld.

Sections 3101 and 3111 impose taxes under the Federal Insurance Contributions Act (FICA) on "wages" as that term is defined in section 3121(a), with respect to "employment" as that term is defined in section 3121(b). The term "wages" is defined in section 3121(a) as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines the term "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific

exceptions.

Rev. Rul. 86-14, 1986-5 C.B. 304, determines that FICA payments that are made on an employee's behalf are additional income to the employee and should be reported as additional wages. The ruling also states that any FICA payments made on the employee's behalf should be reported as "Social Security Tax Withheld" on the Form W-2.

Generally, an employer may correct overpayments of FICA tax after an error has been ascertained using the adjustment process under section 6413 or using the refund claim process under section 6402. An error is ascertained when the employer has sufficient knowledge of the error to be able to correct it.

Under section 31.6413(a)-1(a) and section 31.6413(a)-2(b) of the Treasury regulations, before making an adjustment of an overpayment of FICA tax with respect to an employee, an employer generally must repay or reimburse the employee in the amount of the over-collection prior to the expiration of the period of limitations on credit or refund, and, for FICA tax overcollected in a prior year, must also secure the employee's written statement confirming that the employee has not made any previous claims (or the claims were rejected) and will not make any future claims for refund or credit of the amount of the overcollected FICA tax.

Section 31.6402(a)-2 provides rules under which a refund claim for an overpayment of FICA tax may be made. Pursuant to § 31.6402(a)-2(a), no refund or credit for FICA employer tax will be allowed unless the employer has first repaid or reimbursed its employee for the employee FICA tax or has secured the employee's consent to the allowance of the claim for refund and includes a claim for the refund of such employee tax. However, this requirement does not apply to the extent that the employee FICA taxes were not withheld from the employee or, after the employer makes reasonable efforts to repay or reimburse the employee or secure the employee's consent, the employer cannot locate the employee or the employee will not provide consent.

ANALYSIS

In the tax equalization program described, the United States company reduces the employee's previously agreed upon salary by an approximate hypothetical tax. Under the arrangement, the employee is not entitled to receive the approximate hypothetical tax, and his salary is now equal to the previously agreed upon salary minus the approximate hypothetical tax amount. As such, the approximate hypothetical tax that is removed from the employee's previous salary is no longer wages or income as demonstrated in Rev. Rul. 78-374.[1] The Form W-2 filed for and furnished to the employee includes the new, lower agreed upon salary amount plus any income taxes

[1] PLR 8204074 deals with a similar hypothetical tax issue as the one described in this memorandum. That PLR also concludes that the removed "hypothetical tax" does not constitute income or wages.

that are paid by the employer on the employee's behalf during the calendar year.

The United States company is required to withhold income taxes on all wages or payments for services that the employer and employee agree to treat as wages under § 3402(p)(3) that are paid to the employee, including taxes paid on the employee's behalf. Under tax equalization programs, the employee agrees to the reduced salary in exchange for the United States company paying all of the employee's taxes owed on remuneration the employee receives from that company in both the United States and in the host country. Thus, the employer has a prearranged plan to pay an amount of stated wages to the employee net of income tax withholding (and thus, pay the income tax withholding of the employee out of its own funds rather than deducting the withholding from the employee's stated wages in the year of payment).

This prearranged plan results in additional current income and current wages to the employee in addition to the stated wages. See Rev. Rul. 58-113. Any payments made on behalf of the United States citizen employee by the United States company for taxes owed in the United States and in the host country are included in the employee's income and wages, unless otherwise excepted. See § 31.3401(a)-1(b)(6). The amount of taxes paid on behalf of the employee by the United States employer is deemed to have been withheld by the United States company and should be included in income and wages on the employee's Form W-2, unless otherwise excepted. See Rev. Rul. 58-113; see also Rev. Rul. 86-14(pertaining to FICA wages).

To the extent that the employer of a United States citizen employee working in a foreign country pays an amount of income tax withholding in excess of the amount due under § 3402, the employer can correct any overcollection of income taxes through an interest-free adjustment if the employer discovers the error and repays or reimburses the employee within the same calendar year in which the wages were paid to the employee. See §§ 31.6413(a)-1(b)(2) and 31.6413(a)-2(c)(2); see also Rev. Rul. 2009-39. However, the employer can correct an overpayment of income tax withholding due to an administrative error even if the employer did not discover the error until after the employer filed the return and did not repay the employee within the calendar year. See § 31.6413(a)-1(c)(2). An administrative error involves the inaccurate reporting of the amount withheld. An employer's payment of a specific amount of income tax withholding to the Service based on an estimate of an employee's United States income tax liability does not constitute an "administrative error" simply because the employer realizes after the end of the calendar year that the amount paid over to the Service was excessive.

The United States company can also correct an overwithholding error using the claim for refund process. The employer must first repay or reimburse the employee for the overcollected amount. However, the employer can only claim a refund of overpaid income tax withholding after the close of the calendar year if the employer did not actually withhold the amount from the employee's wages under § 3402. See § 6414 and § 31.6414-1.

In this case, remuneration paid by the United States company, including income tax withholding paid on an employee's behalf, is subject to United States income tax withholding under § 3402. The amounts of United States income taxes paid by the employer are deemed to have been withheld under § 3402 from the employee's wages, and should be reported on the employee's Form W-2 as withheld income taxes. See Rev. Rul. 58-113. Taxes paid under § 3402 are subject to § 6413, so adjustments of overpayments may be made for income tax withholding within the calendar year of payment, but no adjustments may be made in a subsequent calendar year.

No amounts are actually withheld from the regular paycheck of the employee, because the employee has agreed to accept a lower salary in exchange for the employer's agreement to pay all taxes on the employee's behalf. Nevertheless, the United States company is still required to pay over to the Service the amount of income tax withholding owed on the wages paid to the employee. See § 31.3403-1. In the event of an overpayment by the employer of income tax withholding, unless the employer follows the procedures for making an interest-free adjustment or claiming a refund of the overpayment within the same calendar year as the year the wages are paid, these amounts are considered additional wages to the employee under § 31.3401(a)-1(b)(6).

The employer's overpayment does not constitute an administrative error under these circumstances. Although these wages were never paid to the employee, but rather were paid over to the Service to satisfy the employer's obligation to withhold income taxes, they are deemed to be withheld from the employee. Since these payments are wages under § 3401, § 6414 bars the refund of these payments after the close of the calendar year because such payments are considered to have been withheld from the employee's wages.

For FICA tax, under Rev. Rul. 86-14, tax payments that are made on an employee's behalf are additional income to the employee and are FICA wages. Under § 31.6402(a)-2(a), before claiming a refund or credit for FICA tax, the employer must make reasonable efforts to first repay or reimburse its employee for the employee FICA tax and must make reasonable efforts to secure the employee's consent to the allowance of the claim for refund.

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Please call Mikhail Zhidkov at (202) 317-4774 if you have any further questions.