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Accounting for tax costs of an international assignment

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Has your company ever been surprised by a large tax bill for a mobile employee?

When a company sends an employee on a tax equalized assignment, the company agrees to cover the worldwide incremental tax obligations for that employee due to the assignment. Without proper planning and processes, the total costs for the company, or the timing of the tax payments, can result in some very unpleasant surprises.

From an accounting perspective, businesses often record their income and expenses based on either a cash or accrual method of accounting. Under the cash method, income and expenses are recorded at the time cash is received or paid out. This method is simple from an administration perspective, but may not properly reflect the reality of the business. Under the accrual method, income and expenses are recorded as incurred, regardless of when the actual cash is either received or paid out. This method is more complicated, but is often better at matching an expense with the related revenue earned.

Below we discuss different options companies use to account for the tax costs of international assignments, as well as some guidance on how your company can minimize surprise tax payments.

There are three main approaches for accounting for the tax costs of an assignment:

1. Full accrual method
2. Partial accrual method
3. Full cash method

To illustrate these methods, we review each using the same basic fact pattern.

Basic fact pattern

- One-year assignment in 2019.
- Total actual worldwide taxes during the assignment are projected to be $100,000 (based on the tax cost projection prepared at the beginning of the assignment).
- Total hypothetical taxes during the assignment are projected be $40,000 (based on the tax cost projection prepared at the beginning of the assignment). From an assignee's standpoint, the hypothetical tax is similar to a withholding tax; however, it is normally not paid to federal or state taxing authorities. It approximates the assignee's tax burden at home. For payroll and

accounting purposes, it is a reduction to salary and is netted against actual tax payments made by the company in determining the total tax costs of an assignment.

- Projected tax cost to the company is expected be $60,000 (actual taxes of $100,000 less hypothetical taxes of $40,000).
- Final tax costs are determined to be $110,000 in actual taxes and $40,000 for hypothetical taxes, so final net tax cost is $70,000.
- Hypothetical tax of $40,000 is withheld during the assignment period in 2019.
- Tax liability of $110,000 is paid two years after the end of the assignment in 2021.

Summary of Cash Flow by Year				
Paid / (Retained)	**2019**	**2020**	**2021**	**Total**
Actual tax paid	-	-	110,000	110,000
Hypothetical tax withheld	(40,000)	-	-	(40,000)

Detailed discussion of accounting methods

Full accrual method

Under the "full accrual method," the company would record an entry for the projected total tax costs of $60,000 during the assignment (entry in 2019), even though the tax was not actually paid in that year. Additionally, the hypothetical tax withheld from the employee would also be applied to the expatriate tax accrual account (entry in 2019), resulting in a balance of $100,000 in the accrual account at the end of the assignment period. If this method were used, when the actual tax payment of $110,000 is paid two years after the assignment is over, only $10,000 would be recorded as an expense in the year of the payment (entry in 2021 equal to $10,000, calculated as $110,000 actual tax payment less $100,000 in expatriate tax accrual account).

Partial accrual method

If the "partial accrual method" is used, the company would not record an entry for the estimated tax costs of $60,000 since no actual tax payments were made during the assignment period. However, the hypothetical tax withheld from the employee would be applied to the expatriate tax accrual account, resulting in a balance of $40,000 in the accrual account at the end of the assignment period (2019). If this method were used, when the actual tax payment of $110,000 is paid two years after the assignment is over, $70,000 would be recorded as an expense in the year of the payment (entry in 2021 of $70,000, calculated as $110,000 payment less $40,000 in expatriate tax accrual account).

Full cash method

Under the "full cash method," the company would not maintain an expatriate tax accrual account. Instead, the company would record the expatriate tax withholding as a negative expense during the assignment period (2019). When the actual tax payment of $110,000 is paid two years after the assignment is over, the full amount of $110,000 would be recorded as an expense in the year of payment (2021).

Comparison of accounting for tax costs

Annual tax expense (net of hypothetical tax)				
Accounting method	**2019**	**2020**	**2021**	**Total**
Full accrual method	60,000	-	10,000	70,000
Partial accrual method	-	-	70,000	70,000
Full cash method	(40,000)	-	110,000	70,000

Analysis

As you can see, each method will ultimately record the same amount of net tax expense. However, there can be significant differences in the timing of when the tax expenses are accounted for under these three methods. If all of the tax payments for the current year are made in the current year, then the difference between these three methods may be insignificant. However, there can often be timing delays for the payment of tax related to an international assignment. For example, some countries will not require tax payments until after an assessment is issued, which may occur in a subsequent year. Thus, the fact pattern provided above is typical.

As illustrated in the above table for our sample scenario, there would be a significant expense recorded two years after the assignment was over, under the partial accrual or full cash methods. Since the activity related to the expense occurred in 2019, it is generally most appropriate to “match” the timing of the expense recognition as closely as possible to the activity. In addition, the “surprise” expense coming in 2021 could result in other budgeting issues if accounts relating to the 2019 project were no longer available for purposes of offsetting the expense.

There is no perfect method. The full accrual method may result in the most administrative work for the company as it requires upfront planning and tracking. In addition, there may still be expense adjustments in years following the assignment. In the fact pattern above, the final tax costs were only $10,000 more than the projected costs. In some cases, the final tax costs may be significantly more or less than the projected tax costs due to factors such as tax law changes or changes in the assignee's compensation package that were not reflected in the original projection. Nonetheless, the full accrual method typically helps the company minimize unanticipated adjustments to the expense account in years after the assignment period.

In the end, the accounting method selected by a company to budget for the tax costs of an assignment will be dependent on factors such as the number and locations of its assignees, the materiality and importance of budgeting for the business units, and the bandwidth of the accounting and finance teams. By understanding the alternatives, your company can make an informed decision on the accounting methodology that best supports organizational objectives.

Tax accrual process guide
To assist companies in implementing the full accrual method, GTN prepared a "Tax Accrual Process Guide." This guide includes a case study, journal entries, sample T-Accounts, W-2 analysis, and other helpful information.

DOWNLOAD GUIDE

If you have questions regarding this, please contact me at bsipes@gtn.com or +1.619.758.4083, or visit our Mobility Tax Services page to see what assistance we can provide.

The information provided above is for general guidance only and should not be utilized in lieu of obtaining professional tax and/or legal advice.

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