IRS Agrees to Implement Procedures for Verifying Taxpayer Claims under Totalization Agreements

To identify inappropriate claims of exemption from U.S. employment taxes by U.S. workers employed outside the United States and foreign workers employed in the United States, the IRS will implement new verification procedures. This article describes how totalization agreements between the United States and other countries treat employees who are potentially covered by more than one social security system, reviews the new IRS procedures, and discusses the increased importance of individual and employer documentation for valid exemptions.

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On July 17, 2015, the Treasury Inspector General for Tax Administration ("TIGTA") issued an audit report to the IRS highlighting its lack of procedures for identifying individual taxpayers who may be improperly claiming exemptions from U.S. social security taxes under totalization agreements.[1] TIGTA cited deficiencies in the exchange of information between governmental organizations and recommended the IRS implement procedures to confirm that individual and employer U.S. social security taxes are properly paid as outlined in the multinational agreements. The IRS agreed with the recommendations in the audit report and plans to implement certain data collection procedures by March 30, 2016.

With the introduction of new collection procedures between the IRS and the Social Security Administration ("SSA"), it appears the IRS may be better equipped to increase the examination of taxpayers claiming an exemption from U.S. social security taxes. This article seeks to provide an

[1] Treasury Inspector General for Tax Administration, *Improvements Are Needed to Verify Taxpayer Claims for Exemption From United States Social Security Taxes Under Totalization Agreements*, Audit Report Reference Number 2015-30-056 (July 17, 2015), *available at* https://www.treasury.gov/tigta/auditreports/2015reports/201530056fr.pdf (the "TIGTA audit report").

overview of totalization agreements, review the findings of the TIGTA audit report, and discuss strategies employers may implement to assist with documenting valid worker exemptions from U.S. social security employment taxes.

Background

In the late 1970s, the United States began entering into international agreements with respect to social security taxes, called totalization agreements. The agreements seek to eliminate double social security taxation for individual taxpayers who might otherwise be covered by the social security systems of both the home and host taxing jurisdictions. The agreements allow an individual to maintain a "totalized benefit" of social security or retirement benefits when work was performed in multiple countries, even though the individual may not otherwise qualify under the domestic requirements of each social security system. Currently, the United States has entered into totalization agreements with 25 foreign countries,[2] and agreements with three more countries are waiting in the wings, having either been signed or negotiations concluded during 2015.

U.S. Social Security

Social security taxes in the United States are currently governed by the Internal Revenue Code under sections 3101 to 3128, collectively referred to as the Federal Insurance Contributions Act ("FICA").[3] FICA subjects the income of every individual to two additional taxes: (1) *old-age, survivors, and disability insurance* imposes a tax of 6.2 percent on wages;[4] (2) *hospital insurance* imposes a tax of 1.45 percent of wages, with a supplementary tax of 0.9 percent on wages over $200,000 (joint wages of $250,000 for a married couple filing a joint income tax return).[5] An exemption from U.S. social security taxes is allowed during any period in which an individual's wages are also subject to the laws of a social security system of another country covered under an international agreement.[6]

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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[2] See https://www.irs.gov/Individuals/International-Taxpayers/Totalization-Agreements for a current list of the 25 foreign countries that have entered into a totalization agreement with the United States.

[3] Sections 3101-3128.

[4] Section 3101(a).

[5] Section 3101(b).

[6] Section 3101(c).

An employer that fails to properly withhold FICA taxes is liable for the amount that should have been withheld from the employee's wages, plus the employer's share of FICA, plus any applicable penalties. The penalty for failure to make timely deposits of FICA taxes is generally up to 10 percent[7] of the amount of the underpayment. [8] In addition, if a taxpayer has not filed an employment tax return, Form 941, *Employer's Quarterly Federal Tax Return*, a failure-to-file penalty may be assessed on the unpaid tax due, together with a failure-to-pay penalty assessed on the amount of tax shown on a return, up to a combined maximum penalty of 47.5 percent.

If a taxpayer has filed a Form 941 employment tax return but FICA taxes were understated, late filing and late payment penalties would not apply, but a 20 percent negligence penalty could apply if the taxpayer failed to make a reasonable attempt to determine the proper amount of FICA tax.[9] Potential penalties for Form W-2, *Wage and Tax Statement*, reporting failures, for either incorrect or unfiled Form W-2s, may also apply depending on the facts and circumstances.

Potential Double Social Security Taxation

For U.S. citizens or resident aliens who are employees of a U.S.-based employer, the Code generally provides that the U.S. employer is required to report and withhold U.S. FICA taxes regardless of where the employees' services are performed. For example, U.S. citizens hired abroad by an American employer and U.S. citizens who are sent overseas to work for their U.S. employers , are still subject to FICA taxes even though they are working outside the United States. Absent a totalization agreement, these employees may also be subject to social security taxation in the foreign jurisdiction, as many foreign countries require individuals performing services in the country to pay into that foreign country's social security regime.

The inverse situation is equally as prevalent. Foreign nationals working in the United States are subject to FICA taxes on the wages they received for services performed within the United States, regardless of whether they are employed by domestic or foreign employers and irrespective of

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[7] A maximum penalty of 15 percent may apply if the tax remains unpaid for 10 days after receiving a notice and demand from the IRS.

[8] Section 6656(a).

[9] Section 6662.

their citizenship and residence, unless a specific exception applies. Further, it is common for these individuals to continue to be subject to their home country social security system, due to their nationality or employment status, particularly in the case of shorter term assignments

Totalization Agreements

These international agreements generally stipulate that an individual covered under the social security systems of both countries shall pay only into the social security regime of the country of employment. However, there is an exception to this general rule that affects many individuals on international assignments.

The "Detached Worker" Exception

Notwithstanding the above general rule, under most totalization agreements, if employees are sent by their employers to work in another country for a period of no more than five years, they will remain covered and continue to contribute to their home social security systems, and will be exempt from the host country social security taxes. Employees who do not meet the five-year test would fall into the general rule, provided they contribute to the social security system in the country of employment.

Other rules may apply in situations in which an employee is sent to work in multiple foreign countries during the five-year period and the other foreign country is also party to a totalization agreement with the United States. Each totalization agreement should be reviewed separately, as not all agreements include the same five-year period for the detached worker exception.

Documenting an Exemption

The sending employer of an employee meeting the "detached worker" conditions of a totalization agreement will generally request and obtain a "Certificate of Coverage" ("CoC") from the home country where the employee continues to participate in the social security system while on an assignment.[10] The CoC is evidence to support the individual's exemption from the host country social security regime. For employers

[10] An employer, employee, or self-employed individual may submit an application request to obtain a CoC, but for the purposes of this article we have assumed the employer is making the request.

subject to U.S. FICA reporting and withholding requirements, retaining a copy of the CoC will help to substantiate the U.S. exemption from FICA tax reporting and withholding if under audit by the IRS.

While no legal authority exists requiring an employer to retain a copy of a CoC, inclusion of a CoC in the payroll files of the employee covered by the totalization agreement exemption is generally recommended. Quick access to a copy of a CoC may prove useful for employers wishing to provide a timely response to a request for documentation as a result of an IRS notice or audit.

Many employers already obtain a CoC for employees who meet the detached worker exception. However, a valid CoC may also be retained for individuals who "localize" or exceed the five-year limitation in their host country and switch to participation in the host country social security system.

Results of the TIGTA Audit Report

As a result of the audit, TIGTA determined that the IRS is unable to identify taxpayers who may have wrongfully claimed an exemption from U.S. social security taxes under a totalization agreement.[11] The audit identified several instances of taxpayers who claimed an exemption from U.S. social security taxes in previous tax years, but TIGTA was then unable to find any documentation at the IRS to support the claims. Based on its sampling, TIGTA identified a group of individuals who were apparently noncompliant with U.S. social security laws as well as a group of individuals for whom they could not verify the claimed exemption from U.S. FICA taxes based on the data collected at the IRS. [12] TIGTA estimated a potential deficiency of employer and individual FICA taxes of over $1.4 million for those 58 individuals.

From a U.S. perspective, the SSA receives copies of any CoCs issued by foreign countries. The SSA records the data from the CoC and keeps track of the number of CoCs approved by foreign countries under totalization agreements. According to the audit report, the SSA then destroys the CoC documents. Further, the IRS does not have any formal procedures in place to obtain information from the SSA related to CoCs received from other

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[11] TIGTA audit report.

[12] *Id.* at p. 6.

countries.[13] Thus, no sufficient documentation exists for the IRS to substantiate a taxpayer's claim of an exemption from U.S. social security taxes.

Recommended Procedures

TIGTA provided three recommendations to the IRS as a result of the audit findings. According to the recommended procedures, the IRS should:

- Establish procedures with the SSA to periodically acquire CoC data
- Coordinate with the SSA's Competent Authority to request data from foreign countries relating to foreign social security taxes paid by U.S. citizens and residents
- Use the data gathered as a result of these procedures to identify noncompliant individuals or employers with respect to the payment of U.S. FICA taxes

Each of these recommendations, once implemented by the IRS, is meant to increase the IRS's ability to ensure compliance FICA tax obligations under totalization agreements.

IRS Response

While few details were provided by the IRS in its response to the TIGTA audit, it did agree with the recommendations from TIGTA and acknowledged the lack of data sharing between the IRS and SSA.[14] Further, the IRS will work to implement procedures with the SSA and SSA Competent Authority to periodically obtain CoCs and data relating to foreign social security payments. The IRS indicated in its response that it intends to implement the first two recommendations by March 30, 2016. Further, the analysis of this data to identify noncompliant individuals or employers, as part of the third recommendation, will take place by March 31, 2017, if the results from sample Form 1040 examinations indicate broad noncompliance by taxpayers.

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[13] *Id.* at p. 7.

[14] *Id.*, Appendix VII.

Individual Taxpayer and Employer Compliance under the New Procedures

Although the exemption from U.S. FICA taxes remains unchanged for qualified individuals under totalization agreements, the new procedures to be implemented by the IRS represent a possible increased scrutiny of taxpayers claiming an exemption from U.S. FICA taxes.

A CoC is the principal form of documentation an employer or employee can provide the IRS as proof of coverage under a country's social security system. An employee currently claiming an exemption from U.S. FICA taxes without a current CoC should strive to document exempt status by obtaining a CoC, which normally will have been obtained by the employer. Depending on the jurisdiction, it may be possible to receive a CoC that applies retroactively to the beginning of when an individual was first considered a detached worker.

Employers generally should be advised to retain a copy of the CoC and include the copy in the employee's payroll files both to substantiate the exemption from U.S. FICA reporting and withholding requirements and to potentially assist with limiting the employer's exposure to withholding and remittance penalties mandated under FICA.

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