Remote Working Across International Borders: The United States - Inbound and Outbound Employees

Overview

Employers must navigate a complex legal landscape when implementing remote working programs. These programs present special challenges when employers have remote workers crossing into or out of the United States. The alert below highlights nine "traps for the unwary" that often occur when foreign employees work in the U.S. or U.S. employees work abroad. Please see our **prior alert** for a summary of the key risks and issues that can arise with respect to global remote working programs generally, including issues around "permanent establishment" and its impact on corporate tax, data security, corporate liability insurance, and more. The list below is not comprehensive, but should give companies a strong sense of the types of issues that can occur when an employee is allowed to "work from anywhere".

Continued

1. Global Employees Who Wish to Come to the U.S. for Work Face Numerous Potential Income Tax Hazards

U.S. citizens and tax residents are generally taxed on worldwide income.

Regardless of an employer's residence and an employee's citizenship or residence, all U.S.-source income, which would include compensation earned while physically present in the U.S., is subject to tax in the U.S. in the absence of a claim for relief under an applicable tax treaty. However, for any employee who becomes a U.S. tax resident—by spending more than 183 days in the U.S. during a three-year period counting all the days in the current year, 1/3 of the days in the prior year, and 1/6 of the days in the second prior year—or by becoming a lawful permanent resident (a "green card" holder), the U.S. imposes tax on the employee's worldwide income.

This has important implications for both employers and employees as even foreign employers may be required to report the employee's income on a Form W-2 and potentially withhold U.S. tax. For employees who become U.S. citizens or lawful permanent residents ("green card" holders), this tax on worldwide income continues indefinitely, and will not end merely by relocating to another country.

Stock rights granted overseas may not comply with U.S. tax rules regarding deferred compensation.

Section 409A of the U.S. Internal Revenue Code ("Section 409A") prescribes strict rules regarding the time and form of payment of deferred compensation, and its arm is long, often pulling in stock rights like stock options and restricted stock units, unfunded deferral arrangements, and other similar compensation. If a non-U.S. employee comes to the U.S. with outstanding stock rights, it is possible that the award will not satisfy Section 409A or one of its exemptions. Similarly, if a U.S. person goes to work outside the U.S., awards granted by a foreign employer for services performed outside the U.S. may still be subject to Section 409A. The fact that the award is issued outside the U.S. is often not relevant to the Section 409A analysis, as the application of Section 409A will be tied to whether the employee is a U.S. taxpayer or otherwise has U.S.-source income. The stakes are high, as violations of Section 409A result in U.S. tax inclusion when the right vests, an additional 20% tax, and an interest penalty. The employer may also face reporting, withholding and deposit penalties (plus interest) for failure to timely report, withhold and deposit federal income taxes

For example, the exercise price of stock options granted outside the U.S. may be "discounted", either on purpose, or due to a difference in valuation methodologies between the original country and the U.S., and will thus not qualify for the Section 409A exemption that most U.S. companies rely on when they issue stock options to U.S. employees. This means that the stock option would need to satisfy Section 409A's time and form of payment rules in order to avoid adverse consequences; however, due to the design of most stock options, it is extremely unlikely that the stock option will comply.

Employers should therefore take special care to review any stock rights held by foreign employees before they relocate to the U.S. to avoid any tax headaches under Section 409A.

> "The stakes are high, as violations of Section 409A result in U.S. tax inclusion when the right vests, an additional 20% tax, and an interest penalty."

Continued

Non-U.S. funded retirement benefits may inadvertently become subject to U.S. taxation.

Section 402(b) of the U.S. Internal Revenue Code governs the taxation of non-exempt trusts and generally requires that contributions to such a trust be includible in income once the contributions are transferable or no longer subject to a substantial risk of forfeiture. U.S. tax-qualified retirement plans avoid this tax regime by complying with the strict U.S. qualification requirements; however, foreign funded benefit plans will, in almost all cases, not satisfy those requirements. Accordingly, a non-U.S. employee's benefit under such a plan could become subject to Section 402(b) taxation when the employee relocates to the U.S. This can be an extremely unpleasant consequence, as often the current value of the benefit, plus any additional contributions or earnings in future years, can become immediately includible in U.S. taxable income. Employers should be mindful of these potential taxes, and understand how Section 402(b) applies to their foreign funded benefit plans, including the tax treatment of benefits that vested prior to the employee's entry into the U.S., unvested benefits that vest while the employee is in the U.S., and distributions that the employee receives while in the U.S.

2. Local Securities Laws May Apply to New Equity Awards Granted to a Remote Worker

Employers who wish to grant new equity awards to foreign employees in the U.S. may need to ensure that such grants comply with U.S. securities registration requirements or otherwise qualify for an exemption. To the extent necessary, employers should ensure that these foreign employees are counted as part of their U.S. workforce numbers for purposes of tracking applicable share registration or exemption thresholds. Similarly, equity awards granted to U.S. employees while they are overseas may need to comply with local securities law requirements, and these U.S. employees may need to be included as part of the local workforce numbers for tracking purposes.

3. Participation in Employee Benefit Plans May Change—and Not Always for the Better

For U.S. employees seeking to go abroad, employers must take care to understand the impact on the suite of benefits typically available to their U.S. employees, most notably retirement benefits and health and welfare benefits. Can the employee remain eligible to participate in the home country plan, or would it even make sense for them to do so? Are there U.S. or foreign tax implications for continued participation in U.S. plans, or new participation in non-U.S. plans? Similarly, although many companies do not provide as many company-sponsored programs outside the U.S. as they might in the U.S., companies should also be mindful of any impacts on non-U.S. employees who leave their home countries, not only with respect to company-sponsored benefit programs, but also on the employee's participation in national retirement schemes and social insurance programs.

> "Employers may incur additional costs with respect to U.S. employees who relocate overseas if such employees acquire local employment rights."

Continued

4. U.S. Employees Who Move Abroad May Become Entitled to More Generous Benefits Under Local Law

Employers may incur additional costs with respect to U.S. employees who relocate overseas if such employees acquire local employment rights. These rights (such as minimum notice periods, statutory severance pay, and paid leave rights) may be more favorable to the employee – and thus costlier to the employer – than what would have otherwise been provided in the U.S. Additionally, employers may want to take stock of what contractual rights a U.S. employee has before they relocate, in order to determine whether any modifications are necessary to avoid a duplication of benefits (e.g., to clarify that any statutory severance pay under local law reduces the amount of contractual severance the employee would receive upon an involuntary termination).

5. Employees—Including Non-U.S. Citizens—May Be Required to Report Their Non-U.S. Assets and Non-U.S. Accounts to the IRS

The U.S. FATCA law requires certain U.S. taxpayers to report information about their foreign financial assets above a specified reporting threshold on Form 8938, which must be included as part of their annual U.S. federal income tax return. This can include foreign equity awards, foreign stocks, and interests in foreign retirement plans. U.S. taxpayers may also be required to file additional reports, known as "FBAR" or FinCEN 114 reporting, about foreign bank and other foreign financial accounts in addition to Form 8938. U.S. taxpayers may find these reporting requirements newly applicable to them if they relocate overseas and acquire foreign assets. Additionally, foreign employees who relocate to the U.S. may be required to report assets held in their home country if they become tax resident in the U.S. The potential consequences of failing to report are severe: for example, the failure to file an FBAR report could result in a penalty of $100,000 or 50% of the account balance, whichever is greater. Employers may want to inform their employees of these tax reporting requirements as part of their "onboarding" process for remote workers.

> "…foreign employees who relocate to the U.S. may be required to report assets held in their home country if they become tax resident in the U.S."

6. Restrictive Covenants—Such as Non-competes—May Not Be Enforceable in the Employee's New Country of Work

In the U.S., the enforceability of non-competes and other restrictive covenants is governed by state law. Certain states, like California, have enacted statutory bans on employment-based non-competes, while certain other states, like Massachusetts, have delineated specific parameters that non-competes must fit within in order to be enforceable. As a result, employers may find that the non-compete applicable to a foreign employee who relocates to the U.S. is now no longer enforceable without modification, or no longer enforceable at all. Similarly, a non-compete for a U.S. employee that is enforceable in the employee's home state may not be enforceable after the employee relocates. Employers should therefore vet the enforceability of any applicable non-competes or other restrictive covenants under the laws of the new jurisdiction in which the remote worker is based to understand the impact of such laws on these important contractual protections.

7. Employers Need to Ensure That Employees Who Wish to Come to the U.S. Are Authorized to Work There

International employees coming to work in the U.S. must have appropriate work authorization. Broadly, business visitors from certain countries can conduct ancillary work activities such as meeting clients, seeing colleagues or visiting offices during short business visits. However, for longer-term, permanent work activities, a visa is usually required. Employers should vet the immigration requirements well in advance as these processes can add significant delay to an incoming foreign employee’s start date and will be different depending on whether an individual is already in the U.S. when applying. Violation of immigration laws can result in employers facing both civil and criminal liabilities and can have longer term consequences for both employers and individuals.

8. U.S. Citizens Working Abroad Continue to Be Subject to U.S. Income Taxation

U.S. citizens and residents are subject to U.S. federal income tax on worldwide income, or in other words, all income no matter where it is earned or where the individual was physically located at the time the income was earned. Accordingly, U.S. citizens who relocate abroad continue to be subject to U.S. income taxes, in addition to any local taxes that may now apply in their new country of residence or work. The coordination of U.S. tax and local tax is highly complex, often governed by detailed tax treaties between the U.S. government and the local country, which means that in many cases the employee should seek specific tax advice to understand the tax impact of a relocation. However, U.S. citizens and lawful permanent residents are often unable to reduce their U.S. tax obligations under the applicable tax treaty and depending upon the time spent in the foreign jurisdiction, may be unable to avoid local country tax as well. In such cases, the individual may be entitled to claim either the foreign earned income exclusion or a foreign tax credit on their U.S. return.

9. U.S. Citizens and Residents Who Work for American Employers Abroad May Continue to Be Subject to U.S. Social Insurance Taxes

In general, U.S. citizens and lawful permanent residents who work for an American employer outside the U.S. are subject to FICA taxes (Social Security and Medicare taxes). However, their presence in a foreign jurisdiction may also subject them to comparable (and often higher) foreign taxes. Similar concerns arise for foreign employees who are sent to work in the U.S. for foreign employers. To ameliorate the potential double taxation of such employees and coordinate benefits under both countries’ social insurance programs, the U.S. has entered into a series of “totalization agreements.” Under those agreements, employees who are sent to work abroad temporarily (generally, for a period of not more than five years), may continue to participate in their home country’s social insurance programs. However, it is necessary to obtain a “Certificate of Coverage” to avoid social insurance taxes in the host country. If no totalization agreement exists, expatriates and inpatriates and their employers may face a double tax burden.

Continued

Contact Us to Learn More

When implementing remote working programs, employers should be mindful of the pitfalls described above, though they are by no means the only ones. Penalties for non-compliance can be costly, and the lion's share of these penalties can sometimes fall upon the employee, which can create employee relations difficulties and frustrate retention goals. Covington's Global Workforce Solutions practice is well-equipped to handle the complex and cross-disciplinary issues that arise in the remote working space. If your organization is considering a remote working program in the U.S. or internationally, we encourage you to contact anyone in our **Global Workforce Solutions** practice.

Chris Bracebridge
Partner, London
+44 20 7067 2063
cbracebridge@cov.com

Lindsay Burke
Partner, Washington
+1 202 662 5859
lburke@cov.com

William Woolston
Partner, Washington
+1 202 662 5844
wwoolston@cov.com

Carolyn Rashby
Of Counsel, San Francisco
+1 415 591 7095
crashby@cov.com

Michael Chittenden
Of Counsel, Washington
+1 202 662 5295
mchittenden@cov.com

Victoria Ha
Special Counsel, New York
+1 212 841 1063
vha@cov.com

Antonio Michaelides
Associate, London
+44 20 7067 2027
amichaelides@cov.com

COVINGTON