

To Be or Not to Be Self- Employed Versus Employed

On a Foreign Assignment Outside the US

January 30, 2010

by: Marc J. Strohl, CPA
Protax Consulting Services Inc.
www.protaxconsulting.com/

The goal of this article is to provide a comprehensive checklist of information for the US person to consider prior to accepting an assignment outside the US. This article is not designed to teach you the technical competence required to perform self compliance; however it will certainly arm you with the knowledge to determine if your US tax preparer knows all that they should know to provide you with technically competent professional services.

To Be Employed Versus Self-Employed (SE):

Generally it is the author's opinion that if you are employed and you go overseas you have a distinct advantage over being self-employed (SE) overseas:

Although your 'foreign' unreimbursed employee expenses will be excluded from Schedule A it will not affect the FEIE claim, conversely all overseas SE person's Schedule C 'foreign' expenses and applicable 'foreign' self-employed adjustments on IRS Form 1040 line(s) 23-32 (e.g. ½ the SE tax, the SEHI deduction, etc...) dollar for dollar reduce the amount of the \$91,400- for 2009 (2008- \$87,600) FEIE available. This would also apply to any moving expenses whether employed or self-employed, if claimed and to the extent that they are considered foreign they would reduce the amount of the \$91,400- for 2009 (2008- \$87,600) FEIE available dollar for dollar. Moves back to the US are NOT considered foreign.

Additionally, as a SE person net SE income is subject to US FICA (Federal Insurance Contributions Act) taxes- social security (6.2% on the first \$106,800- for 2009 (2008- \$102,000) of wages) and Medicare (1.45% on all wages/ net SE income) taxes, however SE persons additionally end up paying both the employee and employer portions. This effectively combines to 15.3% (6.2% + 1.45% = 7.65% x 2) FICA taxes for all SE persons reporting net income on Schedule C, which is ALWAYS assessable if net income on Schedule C arises. Additionally these FICA taxes are NOT subject to the FEIE or HD and always remain assessable. However persons employed abroad and NOT on US payroll, but instead locally hired on a foreign payroll are NOT subject to US employee FICA taxes AT ALL. They would become subject to the social security tax regime of the respective country in which they work, if any.

There is a way however, that SE persons can avoid US FICA SE taxes. Any "Foreign Controlled Corporation" FCC (where foreign is non US) is deemed to have all of its income earned directly by the controlling US person. So the ability for the deferral of income in a FCC is impossible. However, FCC's have one interesting feature, wherein if all of the net income of an FCC is waged out to the controlling shareholder so as to avoid the above deemed income rule those wages would NOT be subject to the US FICA SE taxes of 15.3%!! This is an option available to US SE persons abroad, that is to do business through an FCC to avoid US FICA SE taxes. However there are onerous US reporting requirements whenever a US person owns directly or indirectly more than 10% of this foreign entity. Additionally you must consider the implications of the host country's social security regime, which might make this suggestion more costly.

As above an additional consideration to enacting an FCC are the myriad of IRS reporting requirements associated with foreign entities, including: Form(s) 5471, 8865 and 8858- dealing with Information Returns of US Persons with respect to Certain Foreign Corporations, Partnerships and/ or Disregarded Entities. The complexity of these respective forms and their instructions and the need to apply US Generally Accepted Accounting Principles (GAAP) in answering these respective forms questions, makes the associated compliance efforts onerous. Further in the majority of cases the author does not have the detailed

information required for such compliance. As such usually it is the foreign accountant or client themselves whom completes these forms.

It therefore, may be easier to have your client put you on payroll as an employee to avoid the FCC issues. As the IRS views the 'substance over legal form' of the employee-employer/ master-servant relationship, it may be possible to declare the earnings on IRS Form 1040, line 7 (versus as an independent contractor/ self-employed on IRS Form 1040- Schedule C) as wages and subject this income to ½ of the SE tax if the client is a US corporation issuing you an IRS Form 1099-MISC. For non US employers there would be no US FICA taxes.

Other Interesting Facts:

- These exclusions are elected and voluntary, so in cases where claiming the election results in exclusion income they should not be elected. This would occur where Schedule C expenses outstrip income and these expenses are added back actually creating income.

Marc J. Strohl, CPA is a Principal at Protax Consulting Services Inc.
He may be reached at: Tel: (212) 714-9070, x. 100, Fax: (212) 714-6654,
Email: mstrohl@protaxconsulting.com
Web site: www.protaxconsulting.com