

## To Be or Not to Be Self- Employed Versus Employed

### On a Foreign Assignment Outside the US

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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, if you are employed overseas you have two distinct advantages over self-employed (SE) individuals.

1) Although 'foreign' unreimbursed employee expenses are excluded from Schedule A and will not affect the amount of the FEIE claim; overseas SE person's using a Schedule C will find that all '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...) will dollar for dollar reduce the amount of the \$95,100 for 2012 (\$92,900- for 2011 and \$91,500- for 2010) FEIE available for use. This would also apply to any 'foreign' moving expenses whether employed or self-employed, if claimed and to the extent that they are considered 'foreign' they would also reduce the amount of the \$95,100 for 2012 (\$92,900- for 2011 and \$91,500- for 2010) FEIE available dollar for dollar. Moves back to the U.S. are **not** considered 'foreign'.

2) Additionally, as a SE person net SE income is subject to U.S. FICA (Federal Insurance Contributions Act) taxes- social security (6.2% on the first \$110,100- for 2012 (2011- \$106,800) 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 U.S. payroll, but instead locally hired on a foreign payroll are not subject to U.S. 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.

To mitigate the above as the IRS views the 'substance over legal form' of the employee-employer/ master-servant relationship under common law and IRS Revenue Ruling 87-41, 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 or if the client is a foreign corporation with no U.S. SE tax implications.

Where clearly the individual fails the common law employee-employer definition or it may be difficult to apply IRS Revenue Ruling 87-41 to avoid U.S. FICA SE taxes then they may consider: 1) going on a foreign payroll or a third party payroll, 2) having the client put you on their payroll, 3) having a non-related person own a foreign entity that in turn pays them a wage or 4) a U.S. SE person abroad may do business directly through a foreign entity to avoid U.S. FICA SE taxes. Where they have not checked the box on Form 8832- Entity Classification Election- to be treated as a disregarded entity assuming a one member disregarded entity that defaults to report on Schedule C- Profit or Loss from a Business- on a cash basis. Assuming the foreign entity is an active business (no Sub Part F income- generally passive income) then we recognize for the shareholder/ owner corporate deferral reporting of salary and dividends on a cash paid basis.

However there are a myriad of onerous U.S. reporting requirements whenever a U.S. person owns directly or indirectly more than 10% of any foreign entity. Form(s) 5471- Information Return of U.S. Persons with Respect to Certain Foreign Corporations, 8865- Return of U.S. Persons with Respect to Certain Foreign Partnerships and 8858- Information Return of U.S. Persons with Respect to Certain Foreign Disregarded Entities - may come into play along with Form 926- Return of a U.S. Transferor of Property to a Foreign Corporation. The complexity of these respective forms and their instructions, including the need to apply U.S. Generally Accepted Accounting Principles (GAAP) makes the associated compliance further burdensome. Further in the majority of cases the U.S. CPA will not have the detailed information required for such compliance. As such usually it is the foreign accountant or client themselves whom must complete these forms.

Other Interesting Facts:

- 1 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.

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