Striker Provides Guidance Relevant to Structuring International Employee Secondments

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When one hears the words "worker misclassification," images of employees being incorrectly treated as independent contractors immediately spring to mind, closely followed by daunting calculations of liability for unpaid and under-withheld employment taxes and potential disqualification of tax-qualified employee benefit plans. Obviously, it is important to get this right, and over the years, the IRS and the courts have provided a substantial amount of guidance in this area, from the 20-factor common law employee test articulated by the IRS in Rev. Rul. 87-41[1] in 1987 to pivotal case law in the 1990s and subsequent years.

However, a different strain of worker misclassification tax issues may arise in other contexts, such as when an employee is seconded (or "loaned") to another company within a corporate group and especially when a U.S. multinational seconds employees to subsidiaries or affiliates outside the United States. Under such an arrangement, it is important to understand the factors that govern whether an individual, indisputably an employee, is employed by one corporate entity or another, which necessarily differ from the factors relevant to determining whether an individual is an employee or an independent contractor. In this regard, a recent Tax Court Memorandum, *Striker*,[2] provides an excellent demonstration of how to analyze which of two parties is the employer of an employee for U.S. federal income tax purposes, an analysis that is particularly instructive for U.S. companies seconding employees overseas, to ensure that the federal tax treatment of such employees and their compensation applies as intended.

1 1987-1 CB 296.

2 TCM 2015-248.

Secondments: Why Does Preserving U.S. Employer Status Matter?

Under a typical international intercompany secondment by a U.S. multinational, the intent of the parties is that the seconded employee will remain an employee of the U.S. employer (the "home employer") while temporarily providing services to a company outside the United States within the corporate group (the "host employer") and a range of benefits and taxes are administered and applied accordingly.

For instance, because the assignment is intended to be temporary, both the secondee and the U.S. employer generally desire the secondee's compensation to continue to be covered for U.S. Social Security purposes while working outside the United States, which is possible provided that the U.S. employer is an "American employer" within the meaning of Section 3121(h).[3]

In addition, there is normally an intent that the secondee should remain eligible to participate in U.S. employee benefit and retirement plans without having to consider whether the foreign host employer is a member of the same controlled group as the U.S. employer or having the foreign company adopt the benefit plans of the U.S. employer so that the secondee may participate in them.

From an equity compensation perspective, there will usually be a desire for the secondee to remain eligible to participate in a tax-qualified U.S. offering under any Section 423 employee stock purchase plan ("ESPP") sponsored by the U.S. employer, rather than being excluded from participation as a result of working for a foreign company that is not eligible to participate in the ESPP or being required to participate in a foreign offering under the ESPP that may not be tax-qualified for U.S. purposes and/or may impose restrictions on the terms of participation in order to comply with foreign laws.[4]

In addition, the U.S. employer will normally want to continue to claim the federal tax deduction for any stock options, restricted stock units ("RSUs"), or other equity compensation awards that it has granted or will grant to the secondee during the secondment, in accordance with Code Section 83(h), which establishes the party entitled to the federal tax deduction where there is a transfer of property in connection with the performance of services, including upon an employee's exercise of a stock

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3 Under Section 3121(b), "employment" includes any service of any nature performed within the U.S. or performed "outside the U.S. by a citizen or resident of the U.S. as an employee for an American employer." "American employer" is defined under Section 3121(h) to include: (1) the United States or any instrumentality thereof; (2) an individual who is a resident of the United States; (3) a partnership, if two thirds or more of the partners are residents of the United States; (4) a trust, if all of the trustees are residents of the United States; or (5) a corporation organized under the laws of the United States or of any state.

4 As explained in the Preamble to the Final Regulations promulgated under Section 423 with application from January 1, 2010, "when a parent corporation adopts an employee stock purchase plan, it may establish separate offerings with different terms under the plan and designate which subsidiary corporations of the parent corporation may participate in a particular offering, provided that the terms of each offering (together with the plan) satisfy the requirements of Treas. Reg. Section 1.423-2(a)(3) . "Based on these Regulations, it is common among U.S. multinationals sponsoring a Section 423 ESPP to designate foreign subsidiaries as participating in a separate offering (or offerings) from the U.S. parent and its U.S. subsidiaries. Further, where the ESPP has been drafted to include a "Non-423 component," such non-U.S. offerings may not in all cases be intended to comply with Code Section 423.

option or vesting of an RSU.[5] Specifically, under Reg. 1.83 6(a), the general rule is that the tax deduction with respect to a stock option (or other equity award) is allowable under Section 162 to the entity "for whom the services were performed" (even if another party granted the award), which requires an identification of the entity of which the individual exercising the stock option (or to whom shares are transferred pursuant to another award) is an employee.[6]

In order to achieve these and other similar goals regarding the U.S. tax and benefit treatment of the secondment, the secondee must remain an "employee" of the U.S. home employer for federal tax purposes, as explained below and illuminated by *Striker*. If the facts and circumstances of a U.S. - international secondment show that the secondee is in fact an employee of the host employer, it may have far reaching federal tax consequences, such as (1) the secondee's break in coverage under the U.S. Social Security system (with potential liability for foreign social taxes previously unpaid based on a social security totalization agreement between the U.S. and the host country); (2) the secondee's ineligibility to participate in the U.S. 401(k) plan or other U.S. employee benefit plans (along with issues arising from any improper participation in such plans by the secondee); (3) the secondee's ineligibility to participate in any U.S. offering under a Section 423 ESPP and potential loss of related tax qualification benefits; and (4) the U.S. company's loss of the federal tax deduction under Code Section 83(h) relating to any equity compensation granted to the secondee.

Employee Status Under the Common Law Employee Test

The Code does not contain a precise definition of "employee" for federal income tax purposes; however, in various employment tax contexts, including under Section 3121(d)(2) (which defines terms for purposes of the Social Security taxes that apply to wages paid to an employee) and in regulations issued under Section 3401 of the (relating to payroll tax withholding and reporting obligations), the term "employee" is defined to include any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee. Such regulations under Section 3401 provide that the relationship of employer and employee generally exists when the person for whom services are performed has the right to control and direct

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5 An RSU is an equity compensation arrangement whereby at grant the employee receives only an unfunded and unsecured promise that he or she will receive shares in the future upon satisfaction of certain vesting conditions, normally including continued employment and/or achievement of performance goals. Pursuant to Reg. 1.83-3(e), the grant of an RSU does not constitute property for purposes of Section 83, given its statement that property does not include "an unfunded and unsecured promise to pay money or property in the future." However, various authorities establish that the transfer of shares to an employee upon vesting of an RSU is a Section 83 event, e.g., Ltr. Rul. 8019053 (Feb. 13, 1990); Notice 2009-85, 2009-45 IRB 598 (Oct. 15, 1990) (defining Section 83 "property" to include a stock-settled RSU "to the extent that the compensation payable under such restricted stock unit is in the form of a transfer following the satisfaction of such vesting condition of shares of stock or other property."); and Ltr. Rul. 8904027 (Oct. 28, 1988) (noting that the employer will be entitled to a deduction under Section 83(h) when the RSUs vest.).

6 Note that the U.S. employer's entitlement to claim a deduction under Section 162 for the cash compensation paid to the employee while on secondment at a foreign subsidiary is governed under a different standard. Specifically, to be deductible by the U.S. entity, the amount paid must proximately and directly benefit the U.S. employer 's own business, including its stewardship activities relating to its ownership of foreign entities. See, for example, *Young & Rubicam, Inc.*, 410 F.2d 1233, 1238-1239 (Cl. Ct. 1969).

the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.[7] That is, an employee is subject to the will and control of the employer not only as to what will be done but how it will be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so.[8] Whether the requisite control exists is determined based on all the relevant facts and circumstances.

Over the years, courts have identified various factors that are relevant in determining whether an employer-employee relationship exists. As noted, in 1987, based on an examination of cases and rulings, the IRS issued Rev. Rul. 87-41, in which it developed a list of 20 factors that may be used to determine whether an employer-employee relationship exists.[9]

The IRS has since supplemented Rev. Rul. 87-41 for training and guidance purposes by grouping the key factors relevant to determining the existence of an employment relationship into three broad categories: (1) behavioral control (e.g., instructions, training); (2) financial control (e.g., significant investment by the worker, unreimbursed expenses, services available to the public, method of payment, opportunity for profit or loss by the worker); and (3) relationship of the parties (e.g., provision of employee benefits, intent of parties/written contracts, permanency, right to discharge, and regular business activity), although the fundamental nature of the analysis remains unchanged.[10]

Similarly, courts consistently use the common law employee test in determining employee status for purposes of the Code, as succinctly stated in *Matthews*:[11] "It is clear that absent indications to the contrary, courts have used the common law test for defining "employee" in tax cases."

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7 Reg. 31.3401(c)-(1)(b).

8 *Id*.

9 Rev. Rul. 87-41's 20 factors are as follows: (1) instructions—an employer will have the right to require an employee to comply with its instructions about when, where and how to work; (2) training—providing training to an individual suggests an employment relationship; (3) integration—if a worker is integrated into the business operations and the success of the business depends to an appreciable degree on the worker's performance of services, it generally means a greater degree of direction and control over the worker, and thus suggests employment; (4) services rendered personally—personal rendering of services by a worker suggests employment; (5) hiring, supervising, and paying assistants—if a worker is provided with assistants that are hired, supervised, and paid by the party for whom services are performed, it suggests employment; (6) continuing relationship—a continuing relationship suggests employment; (7) set hours of work—the establishment of set work hours indicates control, and hence, employment; (8) full time required—if a worker must devote substantially full time to a business, it suggests employment. (9) doing work on employer's premises—working on an employer's premises suggests control over the worker, although the importance of this factor depends on the nature of the work; (10) order or sequence set —if the recipient of services has the right to set the order or sequence in which work must be performed, it suggests employment; (11) oral or written reports to employer—a requirement that a worker submit regular or written reports suggests employment; (12) payment by hour, week, or month—regular, time-based payment, rather than by job or commission, suggests employment; (13) payment of business and/or traveling expenses—payment of a worker's business expenses suggests control over business activities, and lack of investment in the business by the worker, and thus, employment; (14) furnishing of tools and materials—furnishing of tools and materials to a worker suggests employment; (15) significant investment by worker—if a worker invests in facilities, such as an office, it suggests independence from the employer; (16) realization of profit or loss—a worker who can realize profit or loss is generally independent; (17) working for more than one firm at a time—a worker who performs services for more than one firm is frequently independent; (18) making service available to general public—a worker who makes his or her services available to the public is typically independent; (19) right to discharge—the right to discharge a worker suggests control, and thus, employment; and (20) right to terminate—the worker's right to end the relationship at any time without incurring liability suggests employment.

10 See, for example, the IRS's "Worker Classification Training Guidelines: Employee or Independent Contractor" (October 1996) as well as Publication 15-A, Employer's Supplemental Tax Guide (2016).

11 907 F.2d 1173, 1178 (CA-D.C., 1990).

As may be inferred from the nature of the factors outlined above, in Rev. Rul. 87-41, the IRS established the 20 factors in the context of determining whether a worker was an employee of a firm, not in the context of determining by which of two firms an employee was employed. Similarly, the IRS's Worker Classification Training Guidelines and the majority of court precedents in this area are focused on whether an individual is an employee or independent contractor. Accordingly, many of the factors are primarily relevant only to this determination (e.g., whether the individual worker has set hours of work, is required to work full-time, works on the employer's premises and is furnished with tools and materials, is paid by the hour, week, or month (rather than by job or commission), as well as whether the individual realizes a profit or loss, offers services to the general public or to more than one firm at a time), and are not informative as to whether an employee is employed by one entity or another.

Application of the Common Law Employee Test Outside of the Employee/Independent Contractor Context

Fortunately, there are several tax cases that distill the IRS's 20 factor common law employee test for the purpose of determining which of two parties is the employer of an employee for federal income tax purposes. *Striker*,[12] the recent Tax Court Memorandum noted above, is especially clear in this regard and, through analogy, is particularly relevant to the international secondment scenario.

Striker involved a U.S. citizen social scientist who applied to the U.S. Army with the goal of being assigned to a NATO coalition project. He subsequently sought to establish that he had been employed by NATO and not the U.S. Army during his deployments to Afghanistan in 2010 and 2011 in order to exclude a portion of his income in such years from federal taxation under Section 911's foreign earned income exclusion.

In the case, the court explained how to analyze which of two entities is the employer of an employee for U.S. federal income tax purposes, stating:

> Petitioner urges that several factors point to his status as an employee: he did not offer services to the general public; he provided no capital and had no opportunity for profit and loss; and he did not provide his own tools or workspace. But these factors are chiefly relevant in determining whether a person is an independent contractor as opposed to an employee; they shed little light on whether petitioner, concededly an employee, was an employee of the Army or of NATO. The common law factors most relevant to the latter determination are the right to control, the right to discharge, the permanency of the relationship, and the nature of the relationship the parties believed they were creating.[13]

12 See note 2, *supra*.

13 *Id*. at 17.

Applying these factors, the court concluded that petitioner Striker was an employee of the Army because the Army had exclusive authority to hire, discipline, and fire him; it paid his salary and provided all his benefits; it assigned him to the NATO post; directed where he would be deployed and the periods of his service; and it subjected him to the same periodic performance evaluations to which all Department of Defense intelligence personnel were subject. Thus, the court determined that the Army had the right to control, and actually did control, Striker's work. In reaching its conclusion, the court considered that NATO officers supervised Striker's activities on a daily basis; he regularly participated in NATO-sponsored training and workshops, some of which were mandatory; he wore a NATO civilian name tag and badge while performing his duties for NATO; his team leader at NATO conducted his performance evaluations (at the direction of the Army); and the NATO commander, by excluding him from the base, could effectively bring his mission to an end. Nonetheless, on the totality of the circumstances, including that Striker did not apply for a specific NATO position, the court did not find these factors sufficient to establish an employment relationship between NATO and Striker.

The court in *Striker* contrasted the case with *Adair*,[14] a similar case decided by the Tax Court in 1995, where the petitioner, a program analyst with the U.S. Army, was formally transferred from the Army to NATO after having applied to NATO for, and having successfully obtained, a three-year post on NATO's international staff. In *Adair*, the Tax Court found that the petitioner was an employee of NATO, not the Army, during his contract with NATO because he had a formal three-year renewable contract with NATO; he was required to swear an oath of loyalty to NATO and to refuse to accept instructions from the U.S. government; NATO established rules regarding his work hours, holidays, and leave rights; and he was subject to performance evaluations and direction from NATO supervisors regarding his daily activities, the sequence of his tasks, and the means by which the desired results were to be obtained. Further, NATO could terminate the petitioner for reasons including unsatisfactory performance or incapacitation, while the Army did not have the right to require the petitioner's return to the Army before the expiration of the agreed-upon term. In reviewing the relevant factors under the common law employee test and reaching its conclusion, the court in *Adair* noted that "[t]he control factor overlaps many other factors and is often cited as the fundamental or "master" test of an employment relationship:"[15]

Structuring International Secondments to Preserve U.S. Employer Status

Taken together, particularly in view of the explanatory comments and contrasts drawn by the court in *Striker*, *Adair* and *Striker* establish that to ensure that a seconded employee remains an employee of the U.S. home country employer for tax purposes, it is important that both the form and substance of the assignment demonstrate that the home country employer retains the right to control the secondee in all key respects.

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14 TCM 1995-493.

15 *Id*. at 95-3095, citing *Matthews*, 92 TC 351 at 361 (1989).

As a starting point, the terms of the assignment, as communicated to the employee and as set forth in any assignment agreement between the home and host employers, should reflect the intent that the employee will remain employed by the home country for all purposes and should describe the way the assignment will be structured in accordance with such intent, including that the secondee will remain on the home country payroll, will continue to participate in home country retirement plans such as 401(k) plans, and/or will continue to contribute to the home country social security system, as well as expressing the temporary nature of the assignment. Tax equalization of a secondee to his or her home country, such that he or she continues to pay taxes at a rate equivalent to that in the home country, is another indicator of the intent that the secondee will remain a home country employee.

Further, from a substantive perspective, the home country employer should exercise control over the secondee through such means as establishing business plans or performance goals relevant to the assignment for the secondee, requiring regular status updates or reports from the secondee as to job duties, actions and progress, retaining the right to conduct the secondee's performance evaluations and to discipline the secondee, and, importantly, having the exclusive right to discharge the employee.

Striker is also helpful for shining a light on the types of activities in which a secondee may likely engage while on assignment without jeopardizing his or her status as an employee of the home country employer for tax purposes, including that the secondee may be supervised on a day-to-day basis by the host country employer, may participate in host country training, may hold him- or herself out to the public as an employee of the host country,[16] and host country managers may participate and provide input into performance evaluations (which are ultimately controlled by the home country).

Further, it is interesting that neither *Striker* nor *Adair* place any emphasis on the "integration" factor of the common law employee test in determining the employer entity of an employee. For example, in *Striker*, the integration of the petitioner into the daily work of NATO was not considered a basis for treating him as an employee of NATO and he was instead held to be an employee of the U.S. Army notwithstanding such integration.

Similarly, when the IRS or the courts have considered an individual's level of integration into a business as being relevant when applying the common law employee test, it has primarily been in the context of determining whether an individual is an employee or an independent contractor. For example, in the case cited under the integration factor in Rev. Rul. 87-41, in finding that coal unloaders were employees of a coal seller company, the court analyzed the integration factor as follows: "Consideration must also be given to such factors as ... whether or not the individual's services

16 Care must, however, be taken to ensure that a secondee of a U.S. company does not act in a manner that would be deemed to constitute a permanent establishment of the U.S. company (e.g., concluding contracts that are binding on the U.S. company), thereby potentially exposing the U.S. company to corporate tax in the foreign jurisdiction in which the secondee is working. Whether a permanent establishment may be created in a given secondment situation will depend on applicable laws and the terms of any tax treaty between the U.S. and the foreign jurisdiction.

are an integral part of the business of the employer *as distinguished from an independent trade or business of the individual himself* in which he assumes the risk of realizing a profit or suffering a loss."[17] This treatment of the integration factor is typical of other cases and IRS rulings where the integration factor has been applied as part of a determination that individuals are employees rather than independent contractors, including finding that nurses are employees of hospitals,[18] part-time college instructors are employees of colleges,[19] and newspaper deliverers are employees of a newspaper publisher,[20] in each case in part because their function was integral to the business.

Taken together with the analysis in *Striker*, this is helpful because an employee on secondment may often become highly integrated into the business of the host country employer, particularly when the secondee is at a senior level within the organization, and it is important that this should not point to a conclusion that the secondee is an employee of the host employer.

Conclusions and Takeaways for U.S. Employers

As outlined above, through the helpful lens of *Striker*, U.S. employers seconding employees overseas and wishing to maintain an employer-employee relationship for federal tax purposes should structure the assignment so that, on the totality of the circumstances, the facts demonstrate that:

- The U.S. company retains the right to control the employee and the manner in which the work is performed by the employee, as may be demonstrated in a variety of ways, e.g., regular status reports or check-ins with the employee, retention of control over compensation decisions, performance reviews and discipline, and/or establishment of operational or other performance goals for the employee;
- The assignment has a temporary nature, in contrast to the ongoing underlying relationship with the U.S. company;
- All documentation (formal and informal) regarding the assignment reflects the intent that the secondee remain a U.S. employee; and
- The U.S. company retains the exclusive right to discharge the employee.[21]

If such steps are taken, based on the analysis in *Striker*, U.S. employers should be able to structure international secondments to meet the goal of having seconded employees treated for federal tax purposes as employees of the U.S. entity, with its associated benefits, including the employee's

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17 *Silk*, 331 U.S. 704 (1947), 1947-2 CB 167 (emphasis added). See also *Bartels v. Birmingham*, 332 U.S. 126 (1947), 1947-2 CB 174.

18 FSA 695, Vaughn #695 (Aug. 24, 1993).

19 Ltr. Rul. 9105007 (Oct. 29, 1990).

20 Ltr. Rul. 9402001 (Jan. 25, 1993).

21 Note that these factors govern employee status for federal tax purposes. Other tests and factors are relevant to determining employee status for employment law purposes and under federal statutes such as the Fair Labor Standards Act, Title VII, the Age Discrimination in Employment Act, and the Americans with Disabilities Act.

continued participation in U.S. benefit and retirement plans, U.S. Social Security, and U.S. tax-qualified offerings under Section 423 ESPPs, as well as the U.S. employer's continued entitlement to the federal tax deduction for any equity compensation granted to the employee. However, it is important to bear in mind that other actions may need to be taken to protect the U.S. entity from creating a taxable permanent establishment in the host country through the arrangement.

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