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Shadow Payroll

What is Shadow Payroll?

Shadow payroll is a method of complying with international tax regulations while an employee works overseas for an extended period of time. It is typically applicable if the transferred employee works in a foreign country for more than 90 days, or depending on the visa or work authorization of the employee. This varies from country to country.

Simply put, citizens of any country working abroad are subject to taxation, employer withholding, and reporting in the home country. It is a complex process, which requires detailed knowledge and expertise.

Even when a US employee, for example, joins the local-country payroll, there is tax due on the worldwide income i.e. there are tax implications. In this scenario, the compensation and benefits the employee receives while in a foreign country are shadowed, or mirrored, in the home country (US) for calculating, remitting, and reporting applicable taxes.

What is the significance of Shadow Payroll?

As there are liabilities both in foreign countries and in the US, shadow payroll works as an important tool to keep up with government regulations and audit

Now, to comply with the global compliance reporting, the business entities need to fulfill the following requirements:

- The business entity in the US (home country) is required to “shadow” report all the payments and benefits that are paid outside of the US

- The business entity in Canada (host country) needs to “shadow” report all the wages and benefits that are considered taxable income paid outside of Canada.

> Example: As a part of its international expansion strategy, a US-based company sends some employees on a four-year assignment to Canada (host country). During that period, the employees will remain on the payroll of their home country (US) while working in Canada.

Here’s a sample shadow payroll calculation:

	Canadian Shadow Exchange Rate: 1 USD = 1.09 CAD	
Country Payroll	US Payroll	Canadian Payroll
Currency	USD	CAD
Frequency	Monthly	Monthly
Compensation		
Salary	10,736.84	11,703.16
Goods & Service Differential	1,200.00	1,308.00
Housing Benefits	1,000.00	1,090.00
Automobile	400.00	436.00
Dependent Education	600.00	654.00
Canadian Tax Gross Up	4,645.61	5,063.72
US Tax Gross Up	1,034.54	1,127.65
GTL	25.00	27.25
Pre-Tax Deductions		
Hypothetical Tax	(1,662.42)	(1,812.04)
401K Retirement	(536.84)	(585.16)
Health/Dental/Etc.	(225.00)	(245.25)
After-Tax Deducations		
Miscellaneous Non-Cash Benefits	(6,645.61)	(3,307.65)
US Actual Tax Offset	-	-
Miscellaneous Non-Cash Offset	-	(10,368.71)
Tax Withholding		
Federal Tax Withholding	-	(5,063.72)
Social Security Tax Withholding	(1,100.78)	-
Medicare Tax Withholding	(257.44)	-
Colorado (State)	(688.71)	-
Greenwood	(2.00)	-
Net Cash Disbursement	8,498.18	0.00

In this context, setting up a shadow payroll in the home country will allow a company to comply with the tax obligations of the host country while simultaneously paying employees on the US payroll and fulfilling the company’s US tax and social security obligations.

▼ Tax Implications

Implementing shadow payroll for employees working overseas is required due to the variables in taxation. Below are the tax implications for US citizens working for a subsidiary in a foreign country:

Tax Equalization and Hypothetical Tax ("Hypo")

Tax equalization is a method that makes sure employees on international projects or assignments do not pay taxes more than they would have paid in their home country. Through tax equalization, any difference in taxes is offset, and employees pay the hypothetical tax or "hypo" as if they are still residents of their home country.

Tax equalization policies vary widely across different companies and industries. Usually, a foreign assignment is based on business needs rather than employees' desire to take a foreign assignment. Thus, tax equalization helps eliminate higher taxes as a deterring factor for employees considering these assignments.

In other cases, where it is employee-driven, companies often do not offer a tax equalization benefit. In these situations, it is advisable to have a thorough consultation with the employee, HR, and Tax experts about the tax implications, especially if an employee is transferring to a high tax country.

Tax Protection

Tax protection can be implemented in various ways if employees incur local and international taxes that exceed their hypothetical amount of taxes. In such cases, the company gross up the difference and reimburse the employees.

▼ What are the Challenges?

One of the biggest challenges for an organization is figuring out what to calculate, report, and remit. Additionally, that organization must determine how and when it should carry out these activities.

- **Currency differences:** Fluctuations in exchange rates and inflation
- **Local payment obligation:** This is relevant for countries where paying in the local currency is mandatory
- **Tax obligations based on days spent:** The amounts of tax vary based on how many days employees spend in a country. The variation can be between 90 and 183 days
- **Taxable amount:** Calculating taxable amounts is particularly complex in shadow payroll due to variance in which items to be taxed
- **Tax refund:** Getting refunds on overpaid taxes can be complicated process as some countries are reluctant to return the overpaid amount.

Due to these factors, it is important for the payroll department to be familiar with the payroll tax requirements in various countries and the jurisdictions within.

Setting up Shadow Payroll

Setting up shadow payroll seamlessly requires an in-depth knowledge of tax obligations in various countries. It also is crucial to be mindful of all the taxable elements and to perform calculations in a timely matter. Some of the key attributes of efficient shadow payroll calculations include the following:

- Collecting all the taxable elements in the paying country such as salary, bonuses, allowances, pension contributions, and benefits in kind
- Converting the taxable elements to the applicable shadow payroll currency and keeping records them
- Calculating the shadow payroll gross to net considering the local tax obligations
- Deducting and offsetting the "calculated net pay" amount from the shadow payroll calculation, and producing a zero net pay delivery.

After setting up the shadow payroll process, the payroll department of an organization also needs to make sure to revisit and update it after every tax year. It is important to check, at least annually, the existing taxes in the host country and where they are applicable.

▼ Questions?

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