All Change - Where To Be Paid And Foreign Currency Issues

At the time of writing this article, 3 years on from the UK's vote to leave the EU, comments abound as to what has happened or will happen with the UK's exchange rate in event of certain decisions made by the UK electorate or yet to be made by Parliament, at a General Election or a 2nd Referendum. This made me think about foreign exchange rates and some of the related tax issues. Fluctuating exchange rates could of course apply to any country and rates can vary for a variety of reasons. The matter is therefore relevant to all international assignees, business travellers and commuters.

All of this is nothing new and exchange rates have always varied. Pick a period suitable for your specific purposes and you can use statistics/exchange rates to argue your case whichever way you want. Assignees are great at this. They will happily shout when the exchange rate fluctuates to their disadvantage but are far too quiet when fluctuations provide a personal windfall.

If you look at the Sterling/GBP rate to the dollar and euro over a period of time it shows the following (top right):

Date	GBP £: EURO €	Date	GBP £: USD $
20 November 2000	1.67	27 November 2000	1.44
17 September 2007	1.43	24 September 2007	2.04
22 December 2008	1.05	22 December 2008	1.47
6 July 2009	1.16	6 July 2009	1.62
28 July 2014	1.26	28 July 2014	1.44
5 December 2016	1.18	5 December 2016	1.26
27 March 2018	1.14	26 March 2018	1.40
30 May 2019	1.13	31 May 2019	1.26

Rates have gone up and down and spiked at various intervals. This all adds to the HR/Global Mobility challenge.

This article does not pretend to have the answers but instead seeks to raise a number of points to be considered of relevance when sending individuals across borders or where foreign currency issues are involved.

Typical Assignment Scenarios?

If we consider typical assignment scenarios and payment arrangements these include:

- Employed in home country, paid in home country
- Employed in home country, paid in host country
- Employed in home country, paid in home and host or 3rd country
- Employed in host country, paid in home country
- Employed in host country, paid in host country
- Employed in host country, paid in home and host or 3rd country
- Employed in 3rd country, paid in home and host or 3rd country
- Commuters and travellers – persistent and periodic travels, paid in home but regular spending in host.

In all instances, it may be necessary to consider exchange rates and what rate to use to arrive at figures to include within tax returns. For example, do you use the exchange rate at the time of receipt, the average for the year or the rate at the time the tax is due?

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General Tax Principles

A tax return is relatively easy when dealing with just one country and the currency of that country. However, complexities start to arise when looking at foreign currencies and determining the exchange rate to use to convert salary and compensation data into the relevant currency for tax reporting purposes. To my knowledge, all countries want individual tax return reporting to occur in the relevant national currency. For example, a UK national on assignment working in the USA but paid wholly or partly in the UK needs to report taxable income in the USA in US dollars and not GB pounds sterling.

Typically the exchange rate used should be that at the time of receipt. The rates can be taken from, for example, well known currency conversion websites or national newspapers, alternatively official rates may be published. Often, where amounts paid throughout a period are relatively consistent, an average exchange rate for the period may be used for regular salary payments. A spot daily rate is typically adopted for large one off payments such as stock exercises or bonuses. If questioned or audited, the key is to be able to demonstrate to the tax authority how the tax return figures have been derived and that there is consistency to the method of calculation across assignees.

Significant exchange rate fluctuations throughout a year, as could happen with sterling, are generally best dealt with by using the relevant daily exchange rate on each payment date. There can of course be a distinct difference, up or down, between an exchange rate over the course of a tax year.

Clearly where taxes are being paid on an ongoing basis throughout the year, fluctuating exchange rates may cause minimal problems, but where taxes are paid in arrears variations in exchange rates can have a dramatic impact. For example:

- **Scenario 1**
  Pay throughout tax year in Country A is 100 but the individual works in Country B and is liable solely to tax in Country B. Country B does not operate a regular withholding equivalent and tax is due after submission of the tax return on issue of an assessment. The exchange rate is 1 to 1 for the tax year in question and the tax rate is a flat 25%, but at the time of payment of tax the exchange rate is 1 to 1.5. The gross income received is 100 and tax is 25, but the equivalent amount due at the time of payment is a cost of 16.67 in the Country A currency. In this scenario the tax bill effectively decreases.
- **Scenario 2**
  Exactly as above, but at the time of payment of tax the exchange rate is 1 to 0.5. The gross income received is 100 and tax is still 25, but the equivalent amount due at the time of payment is a cost of 50 in the Country A currency. In this scenario the tax bill effectively increases.

This simple example shows how the cost of taxes can vary, purely through fluctuating exchange rates. Tax equalisation could exacerbate the issue as could the involvement of a third country or currency.

When looking at stock transactions, typically you are seeking to ascertain when costs have been incurred and monies received. If a payment is made by an assignee on the acquisition of stock then the relevant exchange rate on that date usually dictates the cost of acquisition. If however, the individual is merely awarded phantom stock and pays nothing on acquisition for this, the taxable figure on eventual payout is usually the fluctuation of the stock price converted at the relevant exchange rate on payout only.

Let us look at the contrasting situation of two individuals who both hold shares in their employer. These shares are owned outright by the employees. Let's assume they both acquired 20,000 shares on the same day at a price of one pound each and both dispose of these a year later whilst they are on assignment and the share price on disposal is still one pound. As far as both employees are concerned they have made no gain or loss. However, the impact of exchange rates can be dramatic. For example:

- **Scenario 3**
  One individual goes on assignment to a country where the exchange rate on acquisition is 1:1 but on disposal the rate has changed to 1:1.5. In this situation the individual would make a gain of 10,000 in the currency of the country of assignment. This gain would typically be taxed in the country of assignment.
- **Scenario 4**
  The other individual goes on assignment to a different country where the exchange rate on acquisition is 1:1 but on disposal the rate has changed to 1:0.5. In this situation the individual would make a loss of 10,000 in the currency of the country of assignment. This loss may be available for use or offset in the country of assignment.

Naturally different countries may have different rules about taxation, but it is feasible for a loss to be turned into a gain or a gain into a loss purely as a result of exchange rate fluctuations and tax is then calculated accordingly. It is a difficult situation when trying to explain to an assignee that they owe taxes based on an exchange rate gain they have never enjoyed!

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Where To Get Paid?

Given that exchange rates can cause the above issues it is not surprising that we often get asked where an individual assignee should be paid. Inevitably this is not solely a tax question, but also a combination of additional factors including: where the individual is likely to reside longer-term, where their liabilities arise, where their regular spending occurs and the capabilities of the payroll function itself.

Dealing with these in turn:

- **Taxes –** when looking at employment income, in most cases liability to taxes arises primarily based on where the individual is working as opposed to where they are paid. As ever there are exceptions, for example, countries which still have a remittance basis such as the UK.
- **Residence –** inevitably individuals typically wish to retain monies in the country where they are likely to reside on a longer-term basis. For example, if an individual is to go on 2 year assignment from Country A to Country B it makes sense to have only local spending money in Country B and to receive the bulk of their income in Country A. This will affect the tax due in Country B as a result of exchange rates.
- **Liabilities –** if there are continuing financial obligations in a home country for example, mortgage, pensions and social security contributions it makes sense to receive sufficient funds in the home country in order to cover the related costs. Similarly, the individual will need sufficient funds in the host country in order to meet housing and living costs.
- **Payroll operation –** most payrolls can cope with making a payment to bank accounts in 2 different countries or operating separate or split payrolls. However, some payrolls cannot cope and equally some employers are adverse to making separate payments or operating separate payrolls.
- **Exchange control –** an additional issue to consider is that of exchange control which is enforced by some countries, for example, Angola, India, Nigeria and South Africa. It is necessary to check ability to move funds freely between countries as in some instances it simply is not possible.
- **Immigration & labour law –** rules on immigration and labour law may dictate that a certain amount of income must be paid in a country in order to gain access or be employed there. Adherence to such rules will be necessary.

In theory, splitting payment between home and host countries balances exchange rate fluctuations but this may not always be possible or desirable from the individual assignee or employer's perspective.

Adjusting Compensation For Exchange Rates

Once compensation items and payment location have been agreed what happens if exchange rates vary?

This depends on the agreement reached and company policy. Many assignees are happy to agree fixed rates which may be specified within contracts. In other cases assignment policies may specify that elements of compensation may be adjusted where exchange rates fluctuate by a certain percentage, typically 10% up or down. This flexibility is necessary to stop constant changes to payments with every little movement but to allow a change for bigger variations. Whatever the policy, be assured that individual assignees keep a very close eye on the impact exchange rates have on them. They will certainly let you know if they are adversely affected and will selectively choose relevant periods to demonstrate this, conveniently forgetting positive impacts or rates over different periods.

From a tax perspective variations in payment merely get converted into the relevant foreign currency at the relevant time.

Banking Charges

Where employers incur banking charges transferring or exchanging funds for employees, these are typically reported as taxable income.

Financial Catastrophe

The impact of exchange rates can be difficult in normal scenarios but looking again at deferred 'Eurozone' troubles what could happen if financial disaster strikes and Italian banks default or Greece pulls out of the Euro?

In theory, Greek tax liabilities derived today in Euros but payable tomorrow would still be due – in Euros presumably? If an individual assignee is paid in new substantially devalued drachmas the tax liability would increase significantly in relative terms. If however, they were paid in a currency other than Euros, the impact of any Euro devaluation would effectively reduce their tax bill.

Notwithstanding theoretical events, a standard currency zone does generally remove the challenges relating to tax and exchange rates, but despite a currency link, external events or pressures can create real problems.

This scenario occurred in early 2015, when the Swiss Franc was decoupled from the Euro and increased substantially in value overnight by circa 20% against the Euro. For individuals paid in Euros, Switzerland suddenly became that much more expensive as an assignment location. For Swiss individuals on assignment to a Eurozone country, continuing payment in Swiss Francs resulted in a 'spending windfall'. This could potentially happen again with a Brexit deal or no-deal with rates fluctuating in the aftermath of any decision. Time will tell which way.

Summary

Countries and currencies may vary but the principles set out in this article should hold true.

Tax is already often difficult to calculate when individuals move across borders. The impact on tax and costs of exchange rate fluctuations adds another layer of complexity. The approach taken by tax authorities to foreign exchange fluctuations and the difficulties these create is in many circumstances neither logical nor sympathetic. Being aware of potential issues can only help.

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