

Breaking Developments in Tax Law

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Foreign Subsidiaries of U.S. Companies May Be Liable for FICA Taxes

On June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008 (“HEART”) was signed into law. HEART, which generally extends various tax relief measures to members and veterans of the U.S. armed forces, amends Section 3121 of the Internal Revenue Code of 1986 (the “Code”) to extend liability under the Federal Insurance Contributions Act (“FICA”) to certain foreign employers.

Prior to the enactment of HEART, FICA taxes only applied to wages earned by U.S. citizens and residents rendering services abroad if paid by an “American Employer” – *i.e.*, a domestic corporation or certain U.S.-owned non-corporate entities. New Section 3121(z) of the Code treats foreign employers as American Employers for purposes of applying FICA to wages paid to U.S. citizens and residents for performing services in connection with a contract between the U.S. government and a member of a domestically controlled group of entities to which the foreign employer belongs.

For purposes of determining whether a foreign employer belongs to a domestically controlled group of entities, HEART modifies the Code’s 80 percent ownership threshold generally required for determining the existence of a controlled group. Under Section 3121(z), a group of entities will constitute a controlled group where more than 50 percent of the voting power or value of all classes of corporate stock, or more than 50 percent of the beneficial interest of a non-corporate entity, is owned by one or more of the other entities within the group.

Beginning in August of 2008, foreign employers falling under Section 3121(z) will be required to make quarterly reports and payments of the requisite FICA taxes on applicable wages using IRS Form 941. In addition, the foreign employer will have to provide IRS Form W-2 wage statements to both the employee and the U.S. Social Security Administration identifying the wages subject to FICA withholding and the amount of FICA taxes withheld. The domestic common parent will remain jointly and severally liable for the FICA taxes and any penalties imposed on its foreign group member and will not be entitled to a deduction in the event such liability is invoked.

Treatment under Section 3121(z) will not apply where an American Employer has already entered into an agreement to pay FICA taxes with respect to its foreign affiliates or where the foreign country in which such services are rendered imposes a tax substantially similar to FICA.

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