

## CLIENT ADVISORY

## FICA REQUIREMENT IMPOSED ON FOREIGN SUBSIDIARIES OF US COMPANIES, RESULTING IN NEW BURDENS FOR MANY GOVERNMENT CONTRACTORS

On June 17, 2008, President George W. Bush signed into law the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART), enacted as Pub. L. No. 110-245, which provides a number of tax benefits and incentives to military personnel, veterans, and other types of public servants, with benefits ranging from housing assistance to positive tax treatment of certain types of compensation. As a partial funding mechanism for these benefits, HEART imposes Federal Insurance Contributions Act (FICA) withholding requirements on compensation provided to US persons by domestically controlled foreign entities in connection with US government contracts. FICA withholding applies to services performed starting August 1, 2008.

FICA is the payroll tax imposed on US employers and employees to fund Social Security and Medicare. If a US citizen or permanent resident is employed outside of the United States, FICA taxes must be withheld only where the employer is an “American employer,” which was previously defined under section 3121(h) of the Internal Revenue Code 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.

Thus, prior to HEART’s enactment, a US employee performing services outside the United States would not be subject to FICA payroll tax withholding where his or her employer was a foreign person—regardless of whether the employer was controlled by or affiliated with a US entity.

Under the Heroes Earnings Assistance and Relief Tax Act of 2008, the definition of “American employer” is extended to include the following situation under section 3121(z):

If any employee of a foreign person is performing services in connection with a contract between the United States Government (or any instrumentality thereof)

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and any member of any domestically controlled group of entities which includes such foreign person, such foreign person shall be treated for purposes of this chapter as an American employer with respect to such services performed by such employee.

A “domestically controlled group” is a group of entities that is at least 50 percent owned by a domestic parent, as defined under an adjusted version of section 1563(a).

Therefore, where a US citizen or permanent resident is working under a US government contract outside the United States for a foreign person who is part of a “domestically controlled group,” then compensation to the US citizen or permanent resident is subject to FICA withholding. Moreover, in these circumstances, the domestic parent of the foreign person is jointly and severally liable, not only for the FICA taxes owed, but also for any penalty imposed upon the foreign subsidiary for failure to pay such taxes or file a return with respect to such tax or wages.

However, there are three important exceptions to the requirement that FICA taxes be withheld by an “American employer” under section 3121(z). First, where the United States has entered into a totalization agreement to coordinate social security taxes with a foreign government, that agreement will apply where it addresses the domestically controlled group situation of section 3121(z).<sup>1</sup> Second, where an American employer has elected to treat a foreign affiliate as an “American employer” pursuant to an agreement under section 3121(l), FICA withholding will continue pursuant to such agreement, instead of section 3121(z). Third, no FICA withholding will apply where the employer demonstrates to the Internal Revenue Service that the compensation paid is subject to a “substantially equivalent” tax imposed by a foreign country. In addition, although the language is not entirely clear, the statute appears to require withholding by foreign subsidiaries performing as subcontractors only if the prime contract is awarded to a member of a domestically controlled group of entities of which the foreign subsidiary

is a member. If the prime contract is awarded to a company that is not a member of the foreign subcontractor’s corporate family, then it appears that the foreign subcontractor does not have to withhold, even if the foreign company is a part of a domestically controlled group of entities.

Therefore, US parent companies with controlled foreign entities that perform contracts with the US government should verify whether any foreign entity employees are US citizens or permanent residents. Where any such employees are US citizens or residents, the parent company should take immediate action to ensure that the controlled foreign entity is complying with FICA requirements.

These provisions could be particularly troublesome as the US government expands the role of contractors supporting the US military overseas. In these circumstances, the US parent company must monitor closely the awards of contracts to their foreign subsidiaries—which often are made by US military facilities based in the theater of operations, without the involvement either of US based contracting officer or the domestic parent company. One should not expect that the exigencies of the situation in the field will help the parent avoid liability if its foreign subsidiary fails to withhold applicable FICA. In addition, it is possible that failures to comply with these new FICA withholding requirements could be grounds for suspension or debarment from being awarded new government contracts, for either the foreign subsidiary, the domestic parent, or both.

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<sup>1</sup> The United States currently has totalization agreements with the following countries: Australia, Austria, Belgium, Canada, Chile, Finland, France, Ireland, Japan, Luxembourg, Germany, Greece, Italy, the Netherlands, Portugal, South Korea, Spain, Norway, Sweden, Switzerland, and the United Kingdom.