Addressing Inequities in the Collection of Social Security Taxes for U.S. Citizens Working Abroad*

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* J.D. Candidate 2001, University of San Diego School of Law. M.S. 1991, B.S. 1989, Arizona State University. The author is a Certified Public Accountant and practiced in public accounting for six years, specializing in taxation, before entering law school.

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I. INTRODUCTION

The first social security tax was enacted by Congress in 1935 as part of an extensive program of social legislation aimed at providing old-age retirement benefits and unemployment benefits for American workers, as well as benefits to needy individuals who were unable to work.¹

Social Security and Medicare taxes are imposed on employee wages and self-employment earnings prior to retirement. One half of the tax is paid by the employer and one half by the employee, with the employer’s portion being paid out of the general funds of the business and the employee’s portion being subtracted from her wages.² With a self-employed individual, the outcome changes. The totality of the tax remains the same; however, the self-employed individual assumes responsibility for both halves of the Social Security and Medicare taxes.³ The same amount of tax is paid, but it is paid completely by the self-employed individual and not shared between employer and employee.

For an employee or self-employed individual working overseas, minor changes in the structure of the business arrangement can result in drastic changes in the rate of tax paid by the individual. This Comment explores the discrepancies in tax liability that result from differences in the facts surrounding the individual’s work environment. It discusses the interaction of the Internal Revenue Code, tax treaties, and

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totalization agreements that affect the Social Security tax liability of the individual. This Comment proposes modest changes in the law designed to reduce discrepancies in the tax, making it more equitable to individuals working overseas.

Example 1. George is an American citizen, domiciled in Arizona, hired by a British firm based in Hong Kong to design and build a golf course in mainland China. The project was expected to last well over a year, with George working overseas the entire time. The question is: how, and by whom, should George be taxed?

The first issue to consider is whether George’s income represents foreign or domestic earnings. United States citizens and residents remain subject to U.S. taxation on their worldwide income whether they are physically present within the U.S. or in a foreign country. The Internal Revenue Code, however, provides for an exclusion of certain foreign earned income if the requirements of 26 U.S.C. § 911 are met.

4. George (name changed) is an actual person. For interest, as well as instruction, the facts of his situation are presented in Example 1. Throughout this Comment, George’s situation will be changed to match the areas of law being discussed. This is intended to assist the reader in understanding the material covered and to demonstrate how minor changes in George’s situation can result in changes, sometimes dramatic, in his tax liability.

5. The first issue discussed in this example deals with George’s income tax liability, not his Social Security tax liability. While the focus of this Comment deals with Social Security taxation, George’s entire tax situation is presented in the first example to provide a brief insight into the complex environment of international taxation.

6. See 2000-1 Stand. Fed. Tax Rep. (CCH) ¶ 3260 (1999). “Citizens or residents of the United States liable to tax. In general, all citizens of the United States, wherever resident, and all resident alien individuals are liable to the income taxes imposed by the Code whether the income is received from sources within or without the United States” (emphasis added). Id. “Who is a citizen. Every person born or naturalized in the United States and subject to its jurisdiction is a citizen” (emphasis added). Id.

7. 26 U.S.C. § 911 (1994). To be a “qualified individual” for purposes of excluding foreign income from gross income, several requirements must be met: (1) The income must be earned income (i.e., wages, commissions) from services performed in the foreign country. See 26 U.S.C. § 911(b). (2) The taxpayer must meet either the (a) Bona Fide Residence Test: A citizen of the United States who is a bona fide resident of the foreign country for an uninterrupted period which includes an entire taxable year. See 26 U.S.C. § 911(d)(1)(A); or (b) Physical Presence Test: A citizen or resident of the United States who, during any 12 consecutive months, is present in the foreign country for at least 330 full days in such period. See id. See 26 U.S.C. § 911(d)(1)(B). (3) Tax Home: The taxpayer must have his tax home in the foreign country. See 26 U.S.C. § 911(d)(3). The “tax home” is defined by § 911(d)(3) to be the place from which traveling expenses are deductible under § 162(a)(2), provided that the taxpayer’s abode is not in the United States. See id.

The fact that George’s wife maintains a home in Arizona does not disqualify George
The Internal Revenue Code excludes from taxation the first $74,000 of foreign earned income that qualifies under 26 U.S.C. § 911. To meet the qualifications for 26 U.S.C. § 911, the taxpayer must have foreign earned income, meet either the Bona Fide Residence Test or the Physical Presence Test, and have a tax home in the foreign country. Income from performing personal services is earned income as it arises from the active efforts of the taxpayer. In addition, the income is sourced where it is earned, so George’s income is from sources outside the U.S. The income is both foreign source and earned income, thus it meets the foreign earned income requirement under 26 U.S.C. § 911. Since the job is expected to last over a year, with George returning to the United States only for brief vacations, he meets the Physical Presence Test requirement. Finally, George maintains a home in China from which he works and from which all traveling expenses are deducted. He therefore also meets the Tax Home Requirement. Therefore, the income earned from this project is eligible for the foreign earned income exclusion. As George’s salary is $70,000 and foreign source, none of his income is subject to U.S. federal income taxation.

The second issue is more complicated. How is George taxed for Social Security purposes? The United States requires that employers, foreign and domestic, withhold Federal Insurance Contributions Act (FICA) and Medicare tax from the wages of all employees working in from having a tax home in China. See Jones v. Commissioner, 927 F.2d 849 (5th Cir. 1991).

11. See 26 U.S.C. § 862(a)(3) (1994) (“(a) Gross income from sources without United States. The following items of gross income shall be treated as income from sources without the United States: ... (3) compensation for labor or personal services performed without the United States ...”). The wages are for services performed. Therefore, the income is earned income and meets the requirements of 26 U.S.C. § 911(b)(1)(A). See supra note 8.
13. See id.
14. As a side note, George owned and maintained a home in Arizona where his wife lived and where he returned between jobs. Therefore, as he was domiciled in Arizona, all income could have potentially faced state taxation even though it was exempt from federal tax. Fortunately for George, Arizona taxation of individuals begins with the federal adjusted gross income and modifies it with additions and subtractions of income and deductions not allowed by the federal code in order to come up with Arizona taxable income. However, foreign earned income excluded from the federal calculation is not an addition to Arizona taxable income (although that is by state statute and not federal statute), and therefore, is not taxable at the state level either.
15. See Social Security Taxes, 2000 U.S. Master Tax Guide (CCH) ¶ 49 (1999). For calendar year[...], 2000, a combined tax rate of 7.65% (6.2% for old-age, survivors, and disability insurance (OASDI) [or FICA]) and 1.45% for hospital insurance ([M]edicare) is imposed on both employer and employee. The
the United States, whether they are citizens of the U.S. or not. The United States also requires that U.S. employers withhold Social Security tax from employees, whether citizens or resident aliens, working overseas for U.S. companies. However, when a U.S. citizen works abroad for a foreign employer, he is generally not subject to Social Security or Medicare liability. In this case, George was working overseas for a British company, so the withholding requirements of the United States would not apply.

Other countries, including England, have their own social insurance programs which have similarities to our Social Security program. For countries with social insurance programs, the employee pays into the program of the country in which the income was earned. George is working in China, not England; therefore, he would be taxed under whatever social insurance program exists in China. China does not have

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[FICA] rate (6.2%) applies to wages within the [FICA] wage base, which is . . . $76,200 for 2000. The [Medicare rate (1.45%) applies to all wages since there is no limit on the amount of earnings subject to the [Medicare portion of the tax.

Id.

16. Imposed on every employee/employer are FICA and Medicare tax on the wages (as defined in § 3121(a)) received by the employee with respect to employment (as defined in § 3121(b)). See 26 U.S.C. §§ 3101, 3111 (1994).

For purposes of this chapter, the term "employment" means any service, of whatever nature, performed (A) by an employee for the person employing him, irrespective of the citizenship or residence of either, (i) within the United States . . . or (B) outside the United States by a citizen or resident of the United States as an employee for an American employer.


As an example of this, if a Japanese auto manufacturer established a branch in the United States, it would be required to withhold Social Security and Medicare taxes on the employees in that branch, whether they were United States citizens or not. Thus, the employees would be subject to the same United States tax withholding whether they were working for the Japanese auto branch in the United States or a U.S. automobile company in the United States.

There are exceptions that exist in the law for nonresident aliens working in the United States under certain conditions. However, this area is beyond the scope of this Comment.


18. See Foreign Income, supra note 1, at A-29.

Where a citizen works outside the United States . . . for an employer which is neither an "American employer" nor a foreign affiliate covered by a FICA election, as a general rule he is exempt from FICA under the Code and cannot elect to be subject to FICA if he wishes to maintain his FICA coverage.

Id.

a social insurance program, so therefore George is not subject to social security/social insurance tax. This means that his wages are completely tax free (for federal income tax, Social Security, and state income tax purposes).

Could the Internal Revenue Service have classified George as self-employed in order to get the FICA and Medicare tax from his income? The Internal Revenue Service may reclassify a worker's status if it finds out that the worker was actually an employee and not an independent contractor. A self-employed individual is subject to self-employment tax on his earned income, regardless of where earned or by whom paid.

In George's situation, this means George would now be subject to self-employment tax on his earnings, even if the earnings themselves were exempt from federal taxation under 26 U.S.C. § 911. This reclassification by the Internal Revenue Service is a possibility, but not a high likelihood. The Internal Revenue Service takes an active role in ensuring that workers are properly classified as employees or independent contractors. The Internal Revenue Service has published Revenue Ruling 87-41 which lists twenty factors it considers in determining employment status. Upon review of these factors, it

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22. While there does not seem to be any precedent of the reverse situation being applied (reclassifying from employee to independent contractor), it may be possible. It is not likely, however. The policy of reclassification appears to protect employees from their employers who seek to reduce tax liability by treating the employee as an independent contractor (self-employed individual), thus making the employee responsible for all of the FICA and Medicare tax and relieving the employer of responsibility for paying any portion of the tax.

23. The self-employed individual's tax liability may be changed by a tax treaty. See supra Part II(B)(2)(b).


During the 1970s, the IRS substantially increased its audit efforts with respect to determining whether workers were being properly characterized for federal employment tax purposes. This effort was motivated by a concern that workers who were treated as independent contractors were placed outside of the federal withholding system, which made it administratively more difficult to monitor whether the workers were complying with the tax laws.

Id.


1. Instructions. "A worker required to comply with others' instructions on when, where, and how to work is usually an employee." IRS's 20-factor test to determine employee or independent contractor status, 1999 Federal Tax Handbook (RIA) ¶ 3003 (1998). George was hired for his expertise in the field. Although the firm may have deferred on how he worked, he was required to be in a certain place at a certain time. This indicates employee status.
2. **Training.** "Training a worker indicates that services are to be performed in a particular method." *Id.* George needed no training due to his existing expertise. This indicates independent contractor status.

3. **Integration.** "Integration of a worker's services into the business operations indicates control." *Id.* George was required to work as part of the team and not given leeway to "do it his own way." This indicates employee status.

4. **Services Rendered Personally.** "Services to be rendered personally indicates control." *Id.* George personally rendered services and was not able to subcontract out the work. This indicates employee status.

5. **Hiring, Supervising, and Paying Assistants.** "The right to hire, supervise, and pay assistants shows control." *Id.* The firm was responsible for hiring, supervising, and paying all workers, including George. George did not have any of his own employees on the job. This indicates employee status.

6. **Continuing Relationship.** "A continuing relationship indicates an employment relationship." *Id.* George was hired for this project and this project alone. This indicates independent contractor status.

7. **Set Hours of Work.** "Set hours of work for the worker indicates control." *Id.*

8. **Full Time Required.** "Full time work indicates control. An independent contractor is free to work when and for whom he chooses." *Id.* George was required to meet deadlines, not to punch a clock. This indicates independent contractor status.

9. **Doing Work on Employer's Premises.** "Work performed on a business's premises suggests control." *Id.* The work was done on the employer's premises. This indicates employee status.

10. **Order or Sequence Set.** "Requiring work be performed in a set order indicates control." *Id.*

11. **Oral or Written Reports.** "A requirement that the worker submit regular or written reports indicates control." *Id.* George was required to report on the status of the project as it progressed. This indicates employee status.

12. **Payment by Hour, Week, Month.** "Payment by the hour, week, or month indicates an employment relationship." *Id.* George received a set weekly salary. This indicates employee status.

13. **Payment of Business or Travel Expenses.** "Payment of business expenses indicates an employment relationship." *Id.* The company paid for all of George's travel and business expenses. This indicates employee status.

14. **Furnishing of Tools and Materials.** "Furnishing of tools and equipment indicates an employment relationship." *Id.* The company provided all needed resources and supplies. This indicates employee status.

15. **Significant Investment.** "Investment by the worker in facilities indicates an independent contractor." *Id.* George had no investment at stake. This indicates employee status.

16. **Realization of Profit or Loss.** "The ability to realize a profit or loss from services indicates an independent contractor." *Id.* George was paid a set salary and would not profit from the business's success or suffer its failure. This indicates employee status.

17. **Working for More Than One Firm at a Time.** "Working for more than one firm at a time indicates an independent contractor." *Id.* George was required to work solely for this firm during the project. This indicates employee status.

18. **Making Services Available to General Public.** "Services available to the general public on a regular and consistent basis indicates an independent contractor." *Id.* George worked on projects for different firms as the jobs arose. This indicates independent contractor status.

19. **Right to Discharge.** "The right to discharge a worker indicates an employment
appears that George is quite arguably an employee and not self-employed.26

II. COLLECTION OF SOCIAL SECURITY TAXES FROM U.S. CITIZENS WORKING ABROAD

A. Social Security Taxation Under the Internal Revenue Code

The Internal Revenue Code, any tax treaty, and any totalization agreement are important in determining the Social Security tax liability of a U.S. citizen working overseas.

1. The Internal Revenue Code

a. I.R.C. §§ 3101 and 3111: The Social Security Tax

The rate of Social Security tax is set by 26 U.S.C. §§ 3101 and 3111. Together, these sections provide that the employee and employer shall each pay one half of the tax. The employee’s half will be deducted from her wages and the employer’s half will be taken as a business expense against revenue. In 1999, Social Security taxes totaled up to 15.3% (the amount over $72,600 will only be taxed at 2.9%). The tax is composed relationship.” Id. George could be fired. This indicates employee status.

20. Right to Terminate. “The worker’s right to terminate his relationship without liability indicates an employment relationship.” Id. George could also quit. This indicates employee status.

26. A taxpayer who desires an advance ruling as to whether a particular worker is an employee or an independent contractor can file a form SS-8 to request a determination by the IRS. If the employer treats their workers as independent contractors, then they run the risk of the IRS reclassifying the worker status to be employees. If the IRS successfully reclassifies an independent contractor as an employee, then the IRS will charge the employer with a 100% penalty (in addition to other penalties and interest) which is equivalent to the tax that they should have been withholding on the employee in the first place. See 26 U.S.C. § 6672(a) (1994).

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. Id. While George met the majority of the tests for employee status, he did not meet all of them. This should not change his employee status, however. The courts use these tests as a guideline, not as a strict ordinance. George’s position is clearly weighted in the direction of employee status, and the IRS’s policy is to protect workers from classification as independent contractors, not to protect independent contractors from classification as employees. Therefore, the chances of George being reclassified as an independent contractor are very slight.

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of two portions: (1) FICA, which is 12.4% of the first $72,600 of salary with employer and employee each paying 6.2%, and (2) Medicare, which is 2.9% of the salary and does not have a wage cap, which means that the entire salary will be subject to Medicare tax. The employer and employee each pay 1.45% of the tax.

Every employer who is required to collect these taxes shall then be liable for the payment of the tax. Hence, the employee is legally liable for the tax, but the obligation to pay the tax rests upon the employer.

b. I.R.C. § 1401: Tax on Self-Employment Income

An individual not working as an employee for another will pay both sides of the Social Security tax when she files her individual income tax return. Self-employment tax is similar to Social Security tax. The difference is that, as the individual is self-employed, she takes on the part of both employer and employee, and is, therefore, responsible for paying both halves of the tax. The tax rates are the same as for the employee/employer relationship.

2. U.S. Citizens Working Abroad for U.S. Companies

United States citizens are subject to income taxation on their worldwide income whether the income’s origin is foreign or domestic. In addition, noncitizens, who are classified as resident aliens for income...

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31. See Nissho Iwai Am. Corp. v. Comm’r, 89 T.C. 765, 776 (1987)(dictum). This statement was applied as an example of a situation in which an entity will be responsible for the tax, but another entity is responsible for the payment of the tax. See id.
32. The tax is calculated when the person prepares her individual tax return. Schedule C of form 1040 is used to calculate income from self-employed businesses. All revenue from a single business as well as expenses related to that business will be listed, and the net income from that business will then be determined. Each business will be treated separately with a separate schedule C for each business. The total income from each Schedule C will then be combined, along with any other self-employment income from other sources; the self-employment tax will be calculated using Schedule SE of form 1040 using that amount.
33. If two spouses have self-employment income, their income will be kept separate, not combined, and the self-employment tax will be calculated separately for each spouse.
34. See 26 U.S.C. § 1401(a), (b) (1994).
tax purposes, are also subject to U.S. income taxation on their worldwide income. In contrast, nonresident aliens are subject to U.S. income taxation only on income derived from U.S. sources.

United States citizens working outside the U.S. generally are subject to FICA if they are employed by an American employer. United States citizens or residents working abroad for U.S. employers are subject to Social Security taxation, which will be withheld from their wages in the same manner as U.S. citizens working inside the United States. As in the case of the U.S. citizen working in the United States, the employer's portion of the Social Security tax is calculated based upon the employee's wages; this portion is deductible as an expense by the company and will be used to reduce taxable income.

The employee may also be subject to the income and social security taxes of the foreign country where she works. She may be compensated for this by the use of a tax credit against her foreign income taxes paid. This credit is given for foreign income taxes paid on foreign income earned. It is expressly not granted for social insurance taxes paid to the foreign country if a social security agreement exists between the United States and the foreign country. A foreign tax credit may only be taken against taxes paid to the foreign country if the payment constitutes an “income tax” in the U.S. sense. As there is currently no statutory guidance on handling the foreign social security tax in the absence of a totalization agreement, the taxpayer is left with the uncertainty of trying to determine the applicability of the tax credit. This could result in a

36. See id.
38. See supra note 16.
40. See id.
42. Such Social Security agreements are generally known as “totalization agreements.”

Notwithstanding any other provision of law, taxes paid by any individual to any foreign country with respect to any period of employment or self-employment which is covered under the social security system of such foreign country in accordance with the terms of an agreement entered into pursuant to section 233 of the Social Security Act shall not, under the income tax laws of the United States, be deductible by, or creditable against the income tax of, any such individual.

Id.
44. See 26 U.S.C § 901. For a discussion of the credibility of the foreign social security tax see infra Part II.A.6.
45. The taxpayer may be able to back into the conclusion that the foreign tax credit is applicable to foreign social insurance taxes paid. See Rev. Rul. 81-39, 1981-1 C.B. 396. The taxpayer is denied a foreign tax credit for social security taxes paid to

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double taxation of the foreign earned income as it is taxed both under the U.S. Social Security system and the social insurance program of the foreign country.46

Example 2. Change Example 1 so that George is working for an American firm in China. George's income would be subject to Social Security taxes of $5,355.47 He would still be exempt from federal income taxes for the same reasons as the first example. This tax increase would be based merely upon the nationality of his employer and not upon the work he was doing or where he was doing it.

Example 3. If George did not meet the "qualified individual" requirement for the foreign earned income exclusion,48 then he would be subject to U.S. federal income taxation,49 Arizona state taxation,50 and Switzerland because a totalization agreement exists. The argument can be made that it is the existence of the totalization agreement that prevents the taking of the credit, and absent the existence of the totalization agreement, the credit would be applicable. See id; see also Rev. Rul. 80-94, 1980-1 C.B. 170. This ruling generated the same result for West Germany as Rev. Rul. 81-39 generated for Switzerland. See id. The ruling of the Internal Revenue Service is also the same: No credit is allowed because a totalization agreement exists. See id; see also Wada v. Commissioner, T.C. Memo 1995-241. In this case, the taxpayer is denied a credit for social insurance taxes paid to Japan (a country without a totalization agreement). See id. The argument presented by the court against allowing the credit is that the petitioner failed to prove that Japanese social security tax was an income tax in the "U.S. sense" as required under 26 U.S.C. § 901. Presumably, therefore, the foreign tax credit would be allowed against foreign social security taxes such as Great Britain’s, Venezuela’s, and Canada’s where the U.S. has recognized that the foreign social insurance tax is a tax in the U.S. sense under 26 U.S.C. § 901.

The credibility of foreign social insurance tax shall be discussed in greater detail in Part II.A.6.

46. Id.
47. Calculation of this tax is $70,000 x 6.2% + $70,000 x 1.45% = $5,355.
48. See supra note 7.
49. Unless the foreign tax rate is equal to or below the U.S. tax rate, some of the income will face double taxation. For example, if the U.S. tax rate is 28% and the foreign tax rate is 30%, then the U.S. tax credit will only provide a credit equal to 28%. Therefore, the foreign earned income will be subject to a combined tax rate of 30% (30% foreign tax less 28% U.S. foreign tax credit = 2% foreign tax not credited plus 28% U.S. tax = 30% total federal tax paid on the foreign earned income). On the other hand, if the foreign tax rate is less than the U.S. tax, the U.S. foreign tax credit will only provide a credit equal to the actual amount of the foreign tax paid. See 26 U.S.C. § 904(a) (1994).

The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer’s taxable income from sources without the United States (but not in excess of the taxpayer’s entire taxable income) bears to his entire taxable income for the same taxable year.

Id.

50. The Arizona income tax is calculated by beginning with federal adjusted gross income.
Social Security taxation. On the positive side, George would be allowed a foreign tax credit on the foreign income taxes paid. This credit would probably result in a dollar-for-dollar reduction of his U.S. federal income tax paid, subject to a few limitations. Unfortunately, the foreign tax credit merely provides a credit for the tax and not an exclusion of the income from taxable income. George would still be subject to payment of the state taxes, the Social Security taxes, and the taxes to the foreign nation. In addition, George would also be subject to the amount of federal income tax that exceeded the allowable U.S. foreign tax credit (if any).


Under 26 U.S.C. § 3121(l)(6), a foreign affiliate of an American employer is any foreign entity in which such American employer has at least a 10% interest. This 10% interest is determined by a 10% ownership of the stock of a corporation or a 10% ownership of the profits of a non-incorporated entity. The term “foreign affiliate” is defined in § 3121(l)(8) to include any foreign corporation in which the American employer owns directly or indirectly at least 10% of the voting stock. Thus a second-tier or lower-tier foreign subsidiary may be covered by a FICA election, provided that the American employer indirectly owns at least 10% of the voting stock of the foreign company that is covered by the election.

A foreign affiliate operating in a foreign nation is generally not subject to the tax laws of the United States. Therefore, absent a special election, income, and then making state adjustments as the Arizona legislature deems appropriate. As discussed above, see supra note 14, the basis for the Arizona state income tax calculation begins with federal adjusted gross income. When the foreign earned income exclusion applies, the federal adjusted gross income never contains the amount excluded, so the Arizona tax calculation will not contain that amount either. However, now there will be a number, containing foreign earned income in the federal adjusted gross income line of the state return; state tax will be calculated based on it. When the income qualified for the foreign income exclusion, there was no federal adjusted gross income, and hence no state taxable income would be calculated.

51. Total tax will be a function of many more factors than seen here; items such as itemized deductions, personal exemptions, salary reductions due to qualified pension plan contributions, and so forth, will be taken into account. The totality of factors affecting the final tax due and payable by the individual, however, is beyond the scope of this Comment.
53. See discussion, supra note 49.
54. See 26 U.S.C. § 3121(l)(6) (1994). “[A]n American employer has a 10-percent interest in any entity if such employer has such an interest directly (or through one or more entities)—(i) in the case of a corporation, in the voting stock thereof, and (ii) in the case of any other entity, in the profits thereof.” Id.
55. Foreign Income, supra note 1, at A-25.
it will be taxed in the manner of a foreign company, and the U.S. employees working for the affiliate will not be subject to U.S. Social Security tax. When the company is a foreign affiliate, the American employer may make a one-time, irrevocable election to be subject to U.S. Social Security tax. This election provides that a foreign affiliate which is not normally subject to the Social Security tax may be subject to the tax if the employer makes this irrevocable election. For an employer trying to qualify her employees for Social Security benefits, this is a valuable election. For an employer trying to reduce her own expenses, this should clearly be avoided.

However, if the election is made under 26 U.S.C. § 3121(l), then the foreign affiliate will be subject to U.S. Social Security tax. Under the election, the American employer pays the full FICA (both employee’s and employer’s share) on all U.S. citizens and resident aliens employed


Agreement with respect to certain employees of foreign affiliate.—The Secretary shall, at the American employer’s request, enter into an agreement (in such manner and form as may be prescribed by the Secretary) with any American employer . . . who desires to have the insurance system established by title II of the Social Security Act extended to service performed outside the United States in the employ of any 1 or more of such employer’s foreign affiliates . . . by all employees who are citizens or residents of the United States, except that the agreement shall not apply to any service performed by, or remuneration paid to, an employee if such service or remuneration would be excluded from the term “employment” or “wages” . . . had the service been performed in the United States.


House Bill—Broadens the availability of social-security coverage to American citizens working abroad by: (1) permitting coverage of American citizens working outside the United States for a foreign affiliate of an American employer; and (2) reducing the ownership interest in the foreign affiliate that is required to be held by the American employer from 20 percent to 10 percent (either directly or through one or more entities).

Id.

58. Section 3121(l) of 26 U.S.C. specifically refers to U.S. citizens and resident aliens working for the foreign affiliate. It makes no reference to treatment of non-resident aliens working for the same foreign affiliate if the election is made. The non-resident alien will not be covered by the election. This makes sense as the company is not a U.S. company (although it is owned, at least in part, by an American employer defined in § 3121(h)), and the non-resident alien, therefore, has no ties to the United States, either through her employer or through where she is working. This should create no problems for the firm in keeping track of payroll or on whom to withhold social security taxes because the U.S. employer (not the affiliate) is responsible for paying both
4. U.S. Citizens Working Abroad for Foreign Companies

When U.S. citizens work for foreign employers, they are taxed on the income earned in that country according to the tax laws of that country. A foreign earned income exclusion will then be allowed for the foreign income earned or a credit allowed on the foreign income taxes paid on foreign earned income. Deductibility or credibility of the foreign Social Security tax is more complicated and is covered in a later section. If the income is earned in a country other than the United States, the employee will not be subject to U.S. Social Security taxation provided that she is not employed by a U.S. company.

A foreign person is not an "American employer" as defined in sections 3121(h) and 3306(j)(3) of the Code. Therefore, because the individual is performing services outside the United States, and the individual's employer is not an "American employer," services performed by an employee are not included within the definition of "employment" for FICA and Federal Unemployment Tax Act (FUTA) purposes. Therefore, remuneration paid to the employee does not constitute wages

halves of the tax (no payroll taxes will be withheld from the employees' wages).

62. See infra Part II.A.5.

For purposes of this chapter, the term "American employer" means an employer which is—

(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,
(5) a corporation organized under the laws of the United States or of any State.

Id.


The term "American employer" means a person who is—

(A) an individual who is a resident of the United States,
(B) a partnership, if two-thirds or more of the partners are residents of the United States,
(C) a trust, if all of the trustees are residents of the United States,
(D) a corporation organized under the laws of the United States or of any State.

An individual who is a citizen of the Commonwealth of Puerto Rico or the Virgin Islands (but not otherwise a citizen of the United States) shall be considered, for purposes of this section, as a citizen of the United States.

Id.
5. U.S. Citizens Working Abroad as Self-Employed Individuals

The self-employed U.S. citizen/resident faces self-employment taxes on all qualified earned income. Unlike the U.S. citizen working for a foreign entity, the self-employed individual will always pay U.S. Social Security tax under the Internal Revenue Code. The exclusions for foreign earned income under 26 U.S.C. § 911 do not apply in computing self-employment tax.°6 Section 1401 of 26 U.S.C. provides that there shall be self-employment tax paid on self-employment income. No provision is provided to limit this taxation based upon where the underlying income is earned.°7

Being self-employed, the individual will pay both halves of the tax°8—12.4% FICA tax and 2.9% Medicare tax—and will be allowed a deduction of one half of the tax on his individual tax return in calculating taxable income.°9 The self-employed individual will, in calculating federal income tax (not Social Security tax), benefit from the same foreign income exclusion and foreign income tax credit as the employee will.°10

Example 4. Consider the same facts as example 1, except that George is now a self-employed individual contracting to do work for this British firm that is developing the golf course in China. Because George is self-employed and this type of income would count as earned income for self-employment purposes,°11 George will pay self-employment taxes of $9,890.69.°72 He still qualifies for the foreign income exclusion for calculating federal income, and he will still be exempt from Arizona state taxes.°73 The self-employment tax is a separate calculation from the federal income tax. It is calculated and then added onto the federal

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°68. See 26 U.S.C. § 1401(a), (b) (1994).
°69. See Line 27, 1999 IRS Federal Form 1040. “One-half of self-employment tax. Attach Schedule SE,” which is a deduction from total income in arriving at adjusted gross income. Id.
°71. See 26 U.S.C. § 1402(b) (self-employment income is defined in this Code section).
°72. Taxes calculated at $70,000 x 15.3% x .9235 = $9,890.69. See 1999 IRS Federal Form 1040 SE for calculation schedule.
°73. See supra note 14.
income tax to be paid together when the individual tax return is filed. George will be allowed a deduction of one half of the self-employment tax in calculating the federal taxable income. However, if the Chinese income is his only income, there will be no federal tax anyway because there is no federal taxable income due to the foreign income exclusion. Hence, the deduction of one half of the self-employment tax will not affect overall taxes paid in this case.

Example 5. Assume that these facts occurred in Germany, where a totalization agreement exists. George would pay social insurance tax to the German government, but he would be exempt from having to pay U.S. self-employment tax.

Example 6. Now assume that the same facts exist in Japan where no totalization agreement exists. George will pay social insurance tax into the Japanese system. He will also pay self-employment tax to the U.S. government. As discussed in the next section, George will be able to take a credit on the social insurance tax paid to Japan but only to the extent that there is other U.S. federal tax against which to apply the credit. As George's only source of income is the foreign income, there will be no other tax against which to apply the credit so the credit will be lost. He will, therefore, pay employment tax on the same income to both countries. Totalization agreements will be discussed in Part II.C.

In the absence of a totalization agreement, the self-employed citizen working overseas may find relief in the application of a tax treaty. Tax treaties will be discussed in Part II.B of this Comment.

6. Deductibility/Credibility of Foreign Social Security Tax Paid

If a totalization agreement exists, the self-employed individual is excused from paying self-employment taxes to the United States if she is already paying it to the foreign country where the income is earned.

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74. See supra note 69.
75. See infra note 138. Totalization agreements will be discussed in Part II.C.
76. See infra note 81.
77. See id.
78. Example 6 assumes that the social insurance tax paid is an income tax in the "U.S. sense" per 26 U.S.C. § 901. For a discussion on whether social insurance/security tax is an income tax, see infra Part II.A.6.
79. Due to the lack of a totalization agreement in the U.S.-Japan Tax Treaty, George will also be denied the benefit of receiving social security/social insurance payments upon retirement, from either country, if he does not accumulate enough annual quarters worked in each individual country to qualify for their social insurance program. This will be the case, even though his combined time worked in both countries would add up to enough years to qualify for one or both programs.
80. See infra Part II.C.
The social insurance payments made to the foreign country pursuant to a totalization agreement will not be deductible or creditable.82

If no totalization agreement or any agreement entered into pursuant to section 233 of the Social Security Act exists, then the self-employed individual may be subject to the social insurance tax of the foreign country as well as that of the United States. There is, however, an argument that a foreign tax credit will be applicable. While the statutory law specifically addresses the non-deductibility of foreign social security tax paid pursuant to a totalization agreement,83 it does not address how to handle foreign social security payments made when no totalization agreement exists (and the self-employed individual potentially faces self-employment taxes payable in both the foreign country and the United States). The courts have also been silent on this issue. It appears that the federal law allows the tax credit; however, absent other federal income tax from which it may be credited, the additional taxes paid will be lost if foreign source self-employment income is the only source of income.

Treasury Regulation § 1.901-2(a)(1) states that for a foreign tax to be deductible against income, it must have the predominant character of an income tax as that term is understood under United States law.84 In order for the foreign social insurance tax to have the predominant character of an income tax the foreign tax must attempt to tax the net gain earned by the individual.85 This means that if the foreign country taxes the gross income earned, without allowing a deduction for business expenses associated with that income to be used to reduce the gross income to net profit (net gain), then the foreign tax will not be an income tax in the U.S. sense, and no foreign tax credit will be allowed to offset it.86

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82. See supra note 43.
83. See id.
86. See Treas. Reg. § 1.901-2(b)(1) (1999). Net Gain: "A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax... satisfies each of the realizati...
Self-employment earnings likely pose a problem since business deductions will probably not be allowed against them in reaching net gain. If, however, the foreign country allows all business deductions to be allocated to self-employment earnings in reducing it to net gain to determine the taxable base, then foreign self-employment tax should be allowed as a credit. Therefore, assuming that self-employment earnings are taxed on their net gain, it appears that foreign self-employment tax, in the absence of a totalization agreement between the United States and the foreign country, will be either deductible or creditable against income or taxes paid in the United States under 26 U.S.C. § 901.

This approach is rational. Under the totalization agreement, U.S. self-employment tax is not payable while foreign social insurance tax must

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2(b)(2) (1999). Gross Receipts: to meet this requirement, the starting point for calculating the tax must be the gross receipts, or gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value. See Treas. Reg. § 1.901-2(b)(3) (1999). Net Income: to meet this requirement, actual expenses attributable to the gross receipts must be allowed to offset those receipts in order to arrive at net income. See Treas. Reg. § 1.901-2(b)(4) (1999). Even if the net gain test is met, the credit may be taken only to the extent that liability for the tax is not dependent on the availability of a credit for the tax against income tax liability to another country. See Treas. Reg. § 1.901-2(a)(3)(ii) (1999). This Comment assumes that these conditions are met.

This Comment uses the assumption that the foreign nation's tax laws are similar to those of the United States in this instance. The Treasury Regulation § 1.901-2(a)(3)(ii) requirement is met if the foreign country does not tax the American self-employed individual only if the United States will provide a credit for the tax. See id. This regulation is designed to counter a foreign country only taxing U.S. individuals conditioned upon the United States providing a tax credit for the foreign country's tax. For purposes of this analysis, the assumption is that the foreign country does not condition its tax in such a manner. Also, the likelihood that a country would only charge social insurance taxes against foreigners under the provision that the foreigner's home country would provide a credit for the tax is negligible.

87. See id.

88. It is unlikely that a foreign country would allow self-employment earnings to be reduced by expenses. The expenses are recorded on the U.S. tax return and subject to U.S. tax laws. The foreign country would have neither the resources nor the interest to determine proper net self-employment income under U.S. tax laws. The foreign country will, however, have both the resources and the interest to ascertain the amount of earnings paid to the U.S. citizen working in their country and to see that such income is taxed.

There are exceptions to this generalization. For example, France allows either (1) actual expenses or (2) a flat 10% of gross salaries (with the percentage rising as high as 40% depending upon the type of work and/or level of income), to be subtracted from gross salaries in order to calculate taxable income. See Foreign Income: Business Operations in France, Tax Mgmt. (BNA) No. 961-2nd, at A-75 (1999).

89. As a side note, a credit is generally preferred to a deduction because a credit is a direct offset against income taxes (usually dollar for dollar), while a deduction is merely a reduction in the taxable income on which the income tax is calculated (so if the taxpayer were in the 28% tax bracket, $1 of credit would result in $1 of tax savings, but $1 of deduction would only result in $.28 of tax savings).
be paid. This results in one level of tax on the earnings. In the absence of a totalization agreement, the self employment/social insurance tax will be paid to both countries, and the foreign tax should be deductible or creditable against the U.S. taxable income or income tax. Once again, this would result in tax payments equal to only one level of tax being paid. Another factor is the economic benefit derived. Under the totalization agreement, the self-employed individual is qualifying for social security benefits in both countries while paying into only one country’s program at a time (that of the country in which she is currently working). Absent a totalization agreement, the self-employed individual pays into both countries’ social security programs with the heightened risk of not being able to qualify for either. Therefore, from a policy standpoint, it makes sense to allow a foreign tax credit to be taken against the foreign social security tax imposed on the self-employment earnings.

However, even if the foreign tax is allowed as a credit or a deduction, there is a serious problem. On federal form 1040, the credits (including the foreign tax credit) are deductible from federal income taxes first, following which other taxes (including self-employment tax) are added into the calculation. The instructions on the form state that if the credits reduce the federal income tax to zero or below, then zero (not a negative number) will be entered on the form and the additional taxes will be added to that zero. In George’s case, this means that because

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90. See supra Part II.C.1.
91. On line 39 of the 1998 IRS Federal form 1040, “Taxable Income” is the amount from which the federal income tax (on line 40) will be calculated. The federal tax credits are lines 41 through 47 of the form with line 46 being the “Foreign Tax Credit.” Credits are totaled on line 48 and subtracted from the line 40 tax. If line 40 is zero or less, then zero is entered on this line.
92. On the 1998 IRS Federal form 1040, Lines 50 through 55 are “Other Taxes” with line 50 being the “Self-employment Tax.” These taxes are then added to the amount from line 40 to determine total tax on line 56.
93. See Internal Revenue Service form 1040. The Internal Revenue Service’s forms and accompanying instructions represent the Internal Revenue Service’s attempt to establish a workable manner for applying the law. The form and instructions themselves, however, are not the law. That the form may now allow for a credit of the foreign social security tax paid does not mean that the law does not allow it. It appears that a valid argument exists for manipulating the form to allow the credibility of the foreign tax. 26 U.S.C. § 904 provides for the allocation of foreign taxes paid to be placed into “baskets” and then offset against U.S. taxes from like “basket” income. Foreign social insurance tax and U.S. self-employment tax would, apparently, fall into the same “basket”, and the form is incorrect as it prohibits this proper offset. Therefore, the form must be manipulated to arrive at the correct tax liability.
there are no federal taxes to pay due to the foreign income exclusion, the foreign tax credit (for the foreign social insurance tax) cannot reduce this to a negative number so it will not affect taxes paid after all; the amount on form 1040 for federal tax less credits will reduce to zero, then the self-employment tax will be added in. This results in double taxation of the social insurance tax, regardless of whether or not it is deductible or creditable by law. The organization of form 1040 prevents an actual crediting of the foreign tax against the U.S. self-employment tax.

If, however, George had earned more than the amount allowed to be excluded under 26 U.S.C. § 911, then that additional amount would be subject to U.S. federal income tax and the foreign tax credit would be allowed against those federal income taxes paid.

B. Social Security Taxation Under Tax Treaties

1. The Purpose of Tax Treaties

"The provisions of [the Internal Revenue Code] shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer." The United States has entered into bilateral income tax treaties with over forty-five countries. Each of the treaties basically deals with the same matters; they generally seek to equalize the taxation of international transactions between the two countries. However, each tax treaty is individually drafted for that country and contains differences between it and other tax treaties. Each tax treaty should be reviewed carefully for the country in which the U.S. person plans to do business or invest, as the treaties may conflict with each other on certain points. For example, the U.S.-France tax treaty provides that French pension retirement income will be tax free in the United States, while the U.S.-Germany tax treaty provides that German pension income will be taxable in the United States. Tax treaties

94. See supra Example 1.
95. See Internal Revenue Service Form 1116.
contain international agreements in force between the countries, such as
an agreement to share information between the Internal Revenue Service
and the taxing body of the foreign country.

Tax treaties contain a series of objectives which generally are on a
reciprocal basis. Their main purpose is to prevent taxes from interfering
with the free flow of international trade and investment. They seek to do
this by avoiding double taxation of income from international
transactions through the limitation of the jurisdiction that each treaty
country may exercise to tax income from domestic sources realized by
residents of the foreign country. Most treaties provide clarification in
areas in which application of the tax laws of the treaty countries may be
ambiguous or unpredictable. They also provide for cooperation between
the taxing authorities of the two nations.100

Each tax treaty, while serving the same basic philosophy of preventing
taxation from interfering with international transactions, is individually
negotiated and differs in content to such extent that it is necessary for the
taxpayer to examine the tax treaty of each country in which the taxpayer
plans to do business.101 Rather than focus on individual tax treaties, this
Comment devotes most of its attention to the current Model Treaty.102

Quite often, the terms of a U.S. tax treaty will modify the tax results
that would have been obtained by the Internal Revenue Code. However,
neither the tax treaty nor the Code is superior to the other; they both

("resident State") are taxable only in the resident State. See id. The resident State will
treat those benefits or pensions as though they were social security benefits paid under its
own social security laws. See id.

100. See GUSTAFSON ET AL., supra note 97, at 50, U.S. tax treaties contain “savings
clauses” which typically exempt a number of treaty provisions from their application as
applied to U.S. persons.

101. While examples are given throughout this Comment to demonstrate
differences between tax treaties, an in-depth analysis of the differences between tax
treaties is beyond the scope of this Comment. See GUSTAFSON ET AL., supra note 95.

102. The Treasury Department publishes its Model Treaty from time to time. The
Model Treaty, in general, represents the current position of the United States in
negotiating treaty arrangements with other countries. It does not, however, reflect the
specific provisions of any treaty actually in force.

Id. at 329.
have equal weight. "For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law." Whenever there is a conflict between the tax treaty and the Code, the later in time prevails.

If examination of the applicable treaties and the tax laws of the United States does not provide a satisfactory answer, then an advance ruling by the Internal Revenue Service may provide the answer. With an advance ruling, a taxpayer may receive a tax ruling from the Internal Revenue Service before entering into the transaction. Except in unusual circumstances, the taxpayer who receives the advance ruling may rely upon it even if the Internal Revenue Service changes its mind (for example, by issuing Regulations to the Code which conflict with the Internal Revenue Service's determination of how the activity should be taxed as stated in the private letter ruling). However, the taxpayer will be required to follow the private letter ruling according to the facts and activity for which the Internal Revenue Service provided the ruling. In order to rely on the ruling, the taxpayer may not deviate from the specific activity as originally laid out. Only the taxpayer to whom the private letter ruling is issued may rely upon the ruling for its dictated tax outcome. "A taxpayer may not rely on a ruling issued to another taxpayer," but a ruling may be used to help determine how the Internal Revenue Service believes that a certain issue should be

104. See GUSTAFSON ET AL., supra note 97, at 58.
105. An advance ruling is commonly known as a private letter ruling.
107. See 2000-18 Stand. Fed. Tax Rep. (CCH) § 43,356 (2000) ("A 'ruling' is a written statement issued to a taxpayer or his authorized representative by the National Office which interprets and applies the tax laws to a specific set of facts. Rulings are issued only by the National Office.").
109. Id.
treated.110 Other taxpayers may rely upon the private letter ruling as substantial authority in the avoidance of underpayment penalties and interest, but not in order to receive the same tax result as provided in the ruling.111 In addition, the Tax Court has also used Private Letter Rulings to articulate a position of the Internal Revenue Service.

2. Application of the Model Tax Treaty to U.S. Citizens Working Abroad

   a. U.S. Citizens Who Are Employees

   In certain treaties, FICA tax may not be taxable under the treaty. This argument proceeds in several steps. The first step is showing that FICA tax is an income tax. This is easy to show as it is considered to be an income tax under the Internal Revenue Code112 as well as by the courts113 and in official positions of the Internal Revenue Service.114

   The next step is to determine which taxes are covered under the tax treaty. This is usually addressed in the treaty section entitled “Taxes Covered.” A tax treaty states that the treaty covers income taxes, and FICA tax has been shown to be an income tax.115 Therefore, under an older treaty, which makes no specific provision for FICA taxes, there is

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110. The IRS has published a general list of transactions for which advance rulings may not be issued. See Rev. Proc. 81-10, 1981-1 C.B. 647.
113. The U.S. Supreme Court characterized FICA tax as an “income tax on employees.” Helvering v. Davis, 301 U.S. 619, 635 (1937).

   It appears that the Internal Revenue Service may have reversed its stance on accepting Social Security taxes as income taxes. This is demonstrated in the current Model Treaty which specifically exempts Social Security from income taxes covered. See infra note 115.

115. Older treaties do not tend to specifically exempt social security from taxes covered, but as the new treaties do. Also note that this analysis assumes that the foreign taxing system is similar to that of the United States. If the foreign country does not treat their social insurance tax as an income tax, then the foreign social insurance tax will not be excluded from the treaty. See Foreign Income, supra note 1, at A-52.
a strong argument that FICA taxes are excluded from taxation in the
same manner as other income taxes are excluded under the treaty.
However, in the newer treaties (and in the 1996 Model Tax Treaty\textsuperscript{116}) the
position of the U.S. Treasury Department has been to provide a specific
exemption from Social Security tax under the treaty.\textsuperscript{117} This provides
that the treaty will cover most forms of income tax, but specifically
exempts Social Security taxes.\textsuperscript{118} In these treaties, the individual would
still be subject to the Social Security tax, even if her income is not
subject to foreign income tax under the treaty. The treatment of the
employer and employee’s share of the FICA tax will also be handled
differently under the treaty.

While it seems fairly certain that a FICA exemption is available to an
individual who is entitled to a federal income tax exemption under an
income tax treaty, it is clear that the exemption applies only to the
employee’s share of the tax and not to the employer’s share. This is
because the employer’s tax is not an income tax but an excise tax which
is measured not by the employer’s own income but by the income of his
employees. Thus, the Code describes FICA on employers as an “excise
tax,”\textsuperscript{119} and the U.S. Supreme Court, in upholding the constitutionality of
the tax, agreed that the tax was an excise within the meaning of Art. I
Sec. 8 of the U.S. Constitution.\textsuperscript{120} Similarly, the IRS has ruled several
times that social security taxes imposed on employers under the laws of
a foreign country are excise taxes rather than income taxes where the tax
is measured by the amount of the employees’ salaries, and thus do not
qualify for a foreign tax credit under the Code.\textsuperscript{121}

\textbf{b. Self-Employed Individuals}

\textit{i. Foreign Self-Employment Income, Income Tax Exemption}

The Model Treaty\textsuperscript{122} provides for relief from the foreign taxation of

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116. See United States Model Income Tax Convention of September 20, 1996, in
CHARLES H. GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 875 (1997)
117. See id. art. 2(1)(a), at 876.
118. Exempting Social Security taxes from the treaty means that even though the
income may not be subject to foreign income tax, the income will still be subject to
foreign social security tax, as foreign social security taxes are no longer covered under
the treaty.
121. Foreign Income, supra note 1, at A-35.
122. The Model Treaty is produced by the U.S. Department of Treasury. It is
published periodically and reflects the Treasury Department’s current position on the
negotiation of international tax treaties.
social security taxes

self-employment income under certain conditions. In order to obtain relief from the foreign taxation, the self-employed individual may not have a fixed base for doing business established in the foreign country.

Activities that provide a fixed base in the foreign country for the self-employed individual include providing an office or fixed place of business in the foreign country, or a dependent agent in the foreign country who (1) may negotiate contracts for the self-employed individual and has the authority to bind the U.S. person, and (2) is not a general commission agent, broker, or other agent of independent status acting in the ordinary course of business. Engaging in activities that create a fixed base in the foreign country means that she will not be able to take advantage of the Model Treaty provision and will have to pay income tax on the self-employment earnings to both the U.S. and to the foreign country to the extent that a foreign tax credit is not available in the U.S.

On the other hand, if there is no fixed base, the Model Treaty provides that the self-employment income will not be taxed by the foreign country, even if earned from sources within the foreign country. Assuming that the foreign country treats social security tax as an income tax, this means self-employment income will not be subject to either foreign federal or foreign social insurance taxation.

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Independent Personal Services
Income derived by an individual who is a resident of a Contracting State in respect of the performance of personal services of an independent character shall be taxable only in that State, unless the individual has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income attributable to the fixed base that is derived in respect of services performed in that other State also may be taxed by that other State.

Id.

124. The term "fixed base" is not defined in the Model Treaty. This can create problems in interpretation as the treaty derives from a different source of law than the Internal Revenue Code and, arguably, their definitions of terms are not interchangeable. Another source of confusion exists because, as each treaty is specifically drafted between the United States and the unique other country in the treaty, the definition of terms such as "fixed base" or "permanent establishment" can and do change from treaty to treaty. One must then look to court cases and committee reports and other related sources to try to ascertain the meaning of any terms not defined in the treaty.

125. See supra note 123.
128. See Gustafson et al., supra note 97, at 51. While meeting the Model Treaty
There is a strong argument that the application of a tax treaty will result not only in exclusion of the foreign self-employment income from foreign taxes, but also in an exclusion of the income from foreign self-employment tax.129

Where an item of income is exempt from federal income tax under an income tax treaty and where the item is otherwise subject to [self-employment taxation] under the Code, it seems fairly clear that the exclusion of the item from gross income by reason of the treaty must have the ancillary effect of exempting the item from [self-employment taxation] as well. This is because any item which is exempt from federal income tax by reason of an income tax treaty is automatically excluded from gross income for all purposes of the Code under § 894, which states, “Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle . . . .”

. . . [T]he starting-point for [self-employment taxation] is the individual’s “gross income” from a trade or business within the meaning of §61. Thus if a particular individual’s income from a trade or business is included in gross income under the Code before application of an income tax treaty, but is excluded from gross income by reason of an income tax treaty and of §894, it seems difficult to reach the conclusion that the exclusion does not apply for [self-employment taxation] purposes.130

Note that this is in sharp contrast to the Internal Revenue Code, which provides that even if foreign earned income is excluded for federal income taxes under 26 U.S.C. § 911,131 the income will, nevertheless, still be subject to self-employment tax.132 The tax treaty removes the income from both the federal income tax calculation and the self-employment tax calculation. This position has not been formally adopted or rejected by the Internal Revenue Service. In contrast to this position, there exists the following counter argument for why the self-employment tax should be assessed, at least in some cases, even though the earnings themselves are excluded from Federal Income tax:

It could be argued nevertheless that §894 must be narrowly construed so as to exempt an individual only from the normal income tax imposed by §1, and not from any of the other taxes that are based on “gross income” but which were not intended to be covered by income tax treaties. This argument would be strongest in the case of those treaties that specifically state in the “Taxes Covered” article that the term “federal income taxes” does not include “social security taxes.” The argument that §894 does not apply for [self-employment taxation] purposes avoids payment of taxes to the foreign country, it does not avoid payment of taxes to the United States.

129. This is in direct contrast with 26 U.S.C. § 1402(a)(11), which provides that even if the foreign earned income is excluded from federal taxation, it will still be subject to self-employment tax. See 26 U.S.C. § 1402(a)(11) (1994).

130. Foreign Income, supra note 1, at A-33.


taxation] purposes would be quite weak in the case of those treaties that do not specifically contain a social security exception in the "Taxes Covered" article, although possibly not as weak under those treaties for which the Treasury's Technical Explanation has stated that it was intended that the treaty not cover social security taxes, even though the treaty was not drafted to actually say this.\footnote{Foreign Income, supra note 1, at A-33 (internal citations omitted).} Under this argument (against excluding self-employment tax in cases where the treaty specifically exempts Social Security tax from taxes covered), the self-employed taxpayer finds herself in a similar position to the U.S. citizen who is an employee under the tax treaty (which specifically exempts Social Security tax from taxes covered).\footnote{See supra Part II.B.2.a.} This would seem to be the most logical position for the taxpayer to take. As stated previously,\footnote{See id.} the Code, the Court and the IRS have all acknowledged Social Security tax (and hence, self-employment tax) as an income tax; therefore, in the treaties that do not specifically exempt Social Security taxes, the taxpayer has an argument for excluding self-employment tax based on the income that is excluded under the treaty (provided that the foreign country recognizes social security tax as an income tax). On the other hand, under the newer treaties and the Model Treaty, where Social Security tax is specifically exempted from income taxes, then the income will be subject to self-employment tax even though the income will not be subject to federal income tax.

Another argument in support of this position is that of equality. This position treats self-employed individuals and employees alike in regard to the assessment of foreign employment taxes in that both the U.S. employee and the U.S. self-employed individual will face foreign employment taxes. To hold otherwise would be to give a distinct competitive disadvantage to U.S. employees over U.S. self-employed individuals by subjecting them to additional foreign employment taxes from which the self-employed individual would be exempt.

C. The Totalization Agreement

Totalization agreements are the third area of international social security taxation that must be addressed in determining the individual's Social Security liability. Totalization agreements are executive
agreements enacted outside of the Code or tax treaties. They are legally binding on the United States in the same manner as income tax treaties or the Code. As of January 31, 1997, the United States had entered into totalization agreements with seventeen countries and discussions were underway in eight others.

1. The Purposes of the Totalization Agreement

A totalization agreement serves two purposes:

(1) relief from double social security tax with respect to the same employment or self-employment, so that social security tax is only paid to one of the two countries on the same income; and (2) the “totalization” of benefits, so that an individual who has paid social security tax to both countries but has not accumulated enough coverage to qualify for benefits in one or both of the countries, may still qualify for benefits from both countries.

136. While totalization agreements modify the tax implications of the Code and the tax treaties, they are unique legal instruments independent of both the Code and the tax treaties. Although totalization agreements are legally binding on the United States in the same manner as income tax treaties, they are literally executive agreements which are “deposited” with each house of Congress, and which under the 1977 enabling legislation become law once 60 sessions days have elapsed without objection by either house in the form of a resolution of disapproval. Thus totalization agreements are acted upon the House as well as the Senate, in contrast with the exclusive jurisdiction that the Senate has over income tax treaties, and they do not require the two-thirds approval that income tax treaties do.

Foreign Income, supra note 1, at A-41.


137. See Foreign Income, supra note 1, at A-41.

138. As of January 31, 2000, the United States had totalization agreements with Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Discussions have taken place with Argentina, Australia, Chile, Denmark, Israel, Japan, New Zealand, and South Korea. See Andre Fogarasi et al., Current Status of U.S. Tax Treaties, 3 TAX MGMT. INT’L J. 184 (2000).

139. Foreign Income, supra note 1, at A-40.
The totalization agreement is subject to two important limitations. First, the permissible scope of totalization agreements is limited to old-age, disability, and survivor's benefits (FICA). Hospital insurance and Medicare benefits are not covered by these arrangements. Second, the legislation requires the accumulation of a minimum of six calendar quarters of coverage by a non-resident alien before the alien may elect to receive ‘totalized’ United States benefits.

Totalization agreements allow periods of coverage in only one of the countries in which the U.S. citizen is employed and in which the U.S. has an agreement (agreement contrary) to be added to periods of U.S. coverage (or “totalized”) when necessary to determine eligibility for U.S. Social Security benefits. This can result in differences both in the amount of tax the individual must pay as well as the level of social insurance benefits that the individual will receive upon retirement. In the United States, in order to qualify for Social Security payments upon retirement, generally, the individual must work forty annual quarters (ten total years) with the Social Security benefits paid to the individual being calculated from the highest thirty-five years of social security wages. Therefore, if a person works only ten years, they will be eligible for social security benefits, but the amount will be minuscule because twenty-five of the thirty-five years used in the calculation of Social Security benefits will be zero.

Where a worker has worked long enough to qualify for benefits from both systems, the pensions remain separate. Where the worker has not worked long enough under either system, the work credits may be combined to provide a “totalized” benefit. Where a worker has worked long enough to qualify for benefits under one system, but not the other, there may be a totalized benefit available from the latter if combining work credits (beyond specific minimum coverage periods) would result in insured (qualifying) status.

Thus, the totalization agreement serves the dual purpose of not only eliminating double taxation, but also helping to ensure that the worker

142. See 20 C.F.R. § 1404.1910 (1984). For example, a worker who needs 40 quarters of coverage to qualify for U.S. Social Security benefits has 20 quarters of U.S. Social Security coverage, 12 quarters of Canadian coverage, eight quarters of U.K. coverage, and no other coverage. This worker cannot qualify for a totalized U.S. benefit, even though the periods of coverage in all three countries total 40 quarters. See 20 C.F.R. § 404.1910.
will qualify for Social Security benefits.

2. **Totalization Agreements and Medicare Benefits**

Section 433(a) of 42 U.S.C. excludes Medicare from totalization agreements.\(^44\) The question then becomes whether or not a person qualifying for Social Security benefits under the totalization agreement will also qualify for Medicare benefits.

Section 404.1911 of 20 C.F.R. states that:

A person may not become entitled to hospital insurance [Medicare] benefits under section 226 or section 226A of the Act by combining the person’s periods of coverage under the social security system of the United States with the person’s periods of coverage under the social security system of the foreign country. Entitlement to hospital insurance benefits is not precluded if the person otherwise meets the requirements.\(^45\)

As a result, a person’s time spent abroad, while applying toward determining her qualification for Social Security, will not help her to qualify for Medicare benefits. The next step is to see if the person is still able to qualify for Medicare benefits in spite of her qualification for Social Security occurring as a result of payment into a foreign social security system. Section 402(a) of 42 U.S.C. provides that in order to qualify for Medicare payments three requirements must be met: \(^46\)

Every individual who—

1. is a fully insured individual (as defined in section 414(a) of this title),
2. has attained age 62, and
3. has filed application for old-age insurance benefits or was entitled to disability insurance benefits for the month preceding the month in which he attained retirement age.\(^47\)

Whether or not the individual is “fully insured” under § 402(a)(1) is provided in § 414(a) which states:

The term “fully insured individual” means any individual who had not less than—

1. one quarter of coverage (whenever acquired) for each calendar year elapsing after 1950 (or, if later, the year in which he attained age 21) and before the year in which he died or (if earlier) the year in which he attained age 62, except that in no case shall an individual be a fully insured individual unless he has at least 6 quarters of coverage; or

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\(^{44}\) 42 U.S.C. § 433(a).

\(^{45}\) 20 C.F.R. § 404.1911 (1999).

\(^{46}\) 42 U.S.C. § 402 provides additional means by which an individual may qualify for Medicare benefits, but for purposes of this paper, the method discussed in 402(a) is the only method relevant as it is the method subject to a potential disqualification by the use of a totalization agreement. See 42 U.S.C. § 402 (1994).

\(^{47}\) Id.
Therefore, an individual who (1) reaches age sixty-two with at least six
quarters of coverage without a break in years (at least one quarter of
coverage obtained each year up until the person is age sixty-two), or (2)
obtains forty quarters of coverage, will qualify for Medicare benefits.
Looking at the first situation, rarely will an individual who is working
overseas also be able to qualify for one quarter of coverage each year in
the United States from the later of 1950 or when she turned 21 (the
exception would be if the individual performed some work in the United
States each year which was enough to qualify for a quarter of coverage,
in addition to her work overseas). The forty quarters of coverage
requirement, however, does not have to be continuous, and gaps may
exist in it.¹⁴⁹

For an individual who spends most of her working years abroad
without employment inside the United States, Medicare (absent one of
the other provisions of 42 U.S.C. § 402)¹⁵⁰ may well be denied to her
when she needs it.

3. Taxation Under the Totalization Agreement

While there are differences in totalization agreements, all but two
contain the following “generic” standards for employees:¹⁵¹ (1) The

¹⁴⁹. The totalization agreement provides for allocation of government retirement
benefits between the countries in which it they are earned. This is not the case with
Medicare benefits. Section 433 of 42 U.S.C. exempts Medicare benefits from the
totalization agreement. See 42 U.S.C. § 433 (1994). Therefore, Medicare benefits will
not be allocated between the countries, but rather, they will be paid by the United States.
Also, if an individual qualifies for Medicare benefits, she qualifies for the full benefit
package that the United States provides. Whether she acquires 6 quarters or 40 may
affect her Social Security benefits, but it will not affect the amount or source of Medicare
benefits which she will receive. See id.
T.I.A.S. No. 9542, at 41. The German agreement is identical to the rules in the “generic”
agreements, except that instead of a five-year rule in the “exception to the exception,” it
provides that the standard territorial rule will apply if the transfer to the host country is
expected to be “permanent.” See Social Security Agreement, November 22, 1977, U.S.-
Italy, arts. 7.4.a., 7.4.b. at 37, 38. The Italian agreement provides that an individual who
is subject to social security tax in both countries remains subject to social security tax
only in the country of which he is a citizen, regardless of how long he remains in the host
country and whether or not he was “sent” to that country as a “detached worker.”
Notwithstanding this general rule, an Italian national, or a dual U.S.-Italian national, may
standard territorial rule provides that the employee is only taxed in the country in which she works (the host country) and not in the country in which she is a citizen (the home country).  

(2) The detached worker exception provides that if the employee is sent from her home country to the host country by an employer located in the home country, he will be subject to Social Security taxation by the home country and not the host country.  

(3) There is an exception to the exception. The detached worker exception will not apply if the employee expects to spend more than five years in the host country (overseas). If this is the case, then the standard territorial rule once again applies, and the employee is taxed in the country in which she works (the host country) instead of the home country.

In sum, the U.S. citizen working overseas will generally be subject to social security tax only in the country in which she is working and not by the United States; but that time spent working in the foreign country will be used in determining if the person qualifies for U.S. Social Security benefits as well as determining if the person qualifies for the social security benefits of the foreign country.

4. Taxation in the Absence of a Totalization Agreement

In the absence of a totalization agreement, the U.S. citizen will be subject to the social security tax systems of both countries. This will result in double taxation to the individual. If the U.S. citizen is working in a country without a totalization agreement, she may not work enough quarters to qualify for the social insurance benefits of either the United States or the foreign country; she will be denied the benefits of both, although she paid into both of them, and her total combined years in both countries would meet the requirements for one or both countries' retirement systems. This would result in her being denied social security benefits by one or both countries. A totalization agreement, on

elect to pay tax to the host country if he does not wish to be taxed by his home country.

See id.

152. See Foreign Income, supra note 1, at A-42.

153. See id.

154. See id.

155. See supra Part II.A.6 for a discussion on the deductibility/credibility of the foreign social security tax paid.

156. If the individual does meet the limits required for social insurance benefits in both countries, then the individual could benefit from the receipt of benefit payments from both countries, with the possibility of the foreign country's benefit payments not being taxed in the U.S. based upon the treaty that the United States has with the country. France is such an example. See discussion, supra note 98. However, the scope of this Comment is addressed at reducing tax payments; therefore, this area is beyond the scope of the Comment.
the other hand, tracks the total quarters worked in both countries, so that if insufficient time is put into either one to qualify exclusively for its social insurance program, but enough combined time would qualify for one country’s program, then each country will pay out its proportionate share of the social insurance benefits that the employee earned.

Example 7. Consider the facts from the first example, with the only change being that George is working for an American company. In this case, he will be subject to Social Security tax of $5,355.00. Note, however, that he does not pay any taxes to China, as China does not have a social insurance program to pay into, nor does it tax the income of foreign nationals working in its country.

Example 8. Consider the facts from example 7, only now George is working in Japan. Japan has a social insurance program but no totalization agreement with the United States. George would, therefore, be forced to pay into the plans of both countries, even though he may never accumulate enough time worked in either country to derive benefits from either country’s social insurance program.

The Code provides an exemption from FICA taxes, if the employment is subject to the social insurance laws of another country and there is an international agreement in place pursuant to section 233 of the Social Security Act. Totalization agreements ordinarily have parallel provisions regarding the other country’s social insurance laws. Thus, the agreements can effectively prevent double coverage by specifying which country’s coverage will govern.

Example 9. Same facts as example 7, only now George is working in England. Due to the totalization agreement, George will only have to pay social insurance taxes to England and not to the United States. The time spent working in England and paying into their social insurance

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Relief from taxes in cases covered by certain international agreements. During any period in which there is in effect an agreement entered into pursuant to section 233 of the Social Security Act with any foreign country, wages received by or paid to an individual shall be exempt from the taxes imposed by this section to the extent that such wages are subject under such agreement to taxes or contributions for similar purposes under the social security system of such foreign country.

Id. (emphasis added). See also 26 U.S.C. § 3111(c) (1994) (providing identical relief for the employer’s share of Social Security taxes); 26 U.S.C. § 1401(c) (1994) (exempting self-employed persons under the same arrangement).

program, will be used in calculating his United States Social Security eligibility.

D. Summary of the Applicable Laws

Determining the tax liability of United States citizens working overseas involves an extremely complicated series of laws presented in three separate areas, all of which must be addressed in order to properly determine the worker's tax liability. First, the Internal Revenue Code must be reviewed to determine the law in the absence of treaties and other agreements (in essence, the default liability). Next, it is necessary to see if a tax treaty exists between the United States and the country where the individual plans to work. Tax treaties specific to the country in which the individual is planning to work must be reviewed to see how they change the outcome of the Code. It is important to note that while the U.S. Model Treaty presents the U.S. Treasury Department's current position on international tax treaties, all treaties are custom tailored for that particular country; therefore, major changes in taxation may result merely based upon the country in which the individual is working. Following this, the worker must determine if a totalization agreement exists between the countries, to prevent the potential double taxation of Social Security tax on wages/earned income. Finally, as mentioned throughout this Comment, there are a number of areas of international social security taxation which have not been fully addressed by any of these three areas of law. The taxpayer may take a position not supported by the law if she has reasonable cause to believe that her position is the correct legal one. However, she will be required to provide notice to the Internal Revenue Service of this unsupported position when she files her federal income tax return. She also has the option of obtaining a Revenue Ruling (private letter ruling) from the Internal Revenue Service which will guarantee her a certain tax result provided that she follows the ruling as stated.

160. See supra Part II.A.
161. See supra Part II.B.
162. See supra Part II.C.
163. The disclosure will be done by filing Form 8275 with the individual's Form 1040 for the year in which the position is taken. See Treas. Reg. § 1.6662-3(a) (1999). A penalty will not be imposed with respect to income tax under-payments attributable to a position contrary to a revenue ruling or notice if the position has a "realistic possibility" of being sustained on its merits. Id. A taxpayer who takes a position on her return that a treaty overrules or otherwise modifies the Code and thereby creates a reduction of any tax incurred must disclose that return position on Form 8833 attached to the return.
164. See supra Part II.B.1. for a discussion of Private Letter Rulings.
III. POSSIBLE SOLUTIONS TO THE DISCREPANCIES

As can be seen, the legal structure affecting the taxation of Social Security for U.S. citizens working abroad is very complex, and minor changes in the person's working environment (such as whether the person is an employee or self-employed, whether she is working for a U.S. firm, a U.S. affiliate, or a foreign firm) can result in large changes in the person's tax liability as well as future Social Security and Medicare benefits. What will be proposed are possible solutions for simplifying the law with a presentation of potential benefits and troubles created by the changes.

A. Eliminate Totalization Agreements

Removal of the totalization agreement would have its greatest strength in qualifying U.S. citizens for Medicare benefits. In general, this would make all wages and earned income subject to U.S. Social Security tax, regardless of where earned or by whom paid, and it would make it much easier for the employee/self-employed individual to qualify for Medicare benefits.

By eliminating totalization agreements, at least one possible drawback exists: potential double taxation of social security taxes both by the host country and the United States. This may be resolved by the imposition of a change in 26 U.S.C. § 904 allowing for the foreign tax to be credited against other taxes under 26 U.S.C. § 901. The imposition of a credit will generally relieve part, but not all, of the foreign social security tax paid as foreign social security taxes are generally much higher than those of the United States. However, this will not change the current

165. The older treaties which do not provide for a specific exception to Social Security taxes will, arguably, result in only the United States assessing Social Security taxes, even in the absence of a totalization agreement. See discussion, supra Part II.C. In countries such as China, where a social insurance program does not exist, the absence of a totalization agreement would not affect foreign social insurance taxation.


situation because, with a totalization agreement, it is the foreign tax that is being paid, not the U.S. tax.\textsuperscript{168} This change in the Code would provide statutory assurance of a credit against foreign taxes in all international social security contexts, and not just with totalization agreements (as discussed before, handling the double taxation absent the agreement is not addressed in the law).\textsuperscript{169}

There is the problem of the loss of the credit, if foreign income is the individual's only source of income and that income was excluded under 26 U.S.C. § 911.\textsuperscript{170} As discussed previously,\textsuperscript{171} the credit will be lost if there is no tax against which to offset it.\textsuperscript{172} However, this once again leaves the individual in the same position that she would be in if working in a country without a current totalization agreement, only now there is the statutory benefit of the credit available. The individual working in a country with a currently existing totalization agreement could end up paying higher taxes, but this would be offset by the enhanced opportunity to qualify for Medicare benefits.

There is also the potential problem of increased administrative costs, particularly for foreign employers who would now be forced to abide by U.S. laws in calculating social security tax on their U.S. citizen employees, withholding the tax, and paying it to the U.S. Treasury, as

<table>
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<th>Country</th>
<th>Income</th>
<th>Social-Employee</th>
<th>Social-Employee</th>
</tr>
</thead>
<tbody>
<tr>
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<td>35.0%</td>
<td>17.00%</td>
<td>32.00%</td>
</tr>
<tr>
<td>Brazil</td>
<td>27.5%</td>
<td>7.82%-11%, with limit</td>
<td>34.00%</td>
</tr>
<tr>
<td>Chile</td>
<td>45.0%</td>
<td>23.30%</td>
<td>0.9%-13.4%</td>
</tr>
<tr>
<td>Peru</td>
<td>30.0%</td>
<td>20.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>United States</td>
<td>39.6%</td>
<td>7.65%</td>
<td>7.65%</td>
</tr>
</tbody>
</table>

\textit{Id. at 11. See also 26 U.S.C. § 904(c) (1994).} Any unused credit may be carried forward for five years or back for two years to offset income taxes in those years. \textit{See id.}

168. With a foreign tax credit, the credit is allowed to the extent that U.S. tax would be applied to the same income. If the U.S. tax rate is higher than the foreign tax rate, only the actual foreign tax may be credited. If the foreign tax rate is higher than the U.S. tax rate, only the amount equal to the U.S. tax rate will be credited, and the remainder must be carried forward five years, back two years, or lost.

The credit method provides a slight advantage over the current totalization agreement structure, which generally provides that the person only pay the employment taxes of the country in which they are working. As they are generally working in a country with higher employment taxes than the U.S., the excess tax paid will provide a disadvantage to the U.S. citizen working overseas as opposed to his U.S. based competition which pays a lower rate of employment tax.

With the elimination of the totalization agreement and the adoption of a foreign tax credit to replace it, the excess foreign tax paid may be used to offset U.S. taxes in another year, thus providing a lessening of the foreign employment tax burden.


171. \textit{See id.}

172. \textit{See 26 U.S.C. § 904(c).} The excess foreign tax credit may be carried back two years or carried forward five years. \textit{See id.}
well as filing the forms required by the Internal Revenue Service. The administrative cost and increased taxes from withholding U.S. FICA tax from their U.S. employees might make it cost prohibitive to employ U.S. workers, which would give the U.S. citizen a distinct disadvantage in the international arena. A possible solution for this problem would be to treat the U.S. employee working for a foreign employer in the same fashion as the self-employed individual is currently treated. The employee would be responsible for the payment of her own Social Security tax which would be calculated and paid with the filing of her Federal Income tax return. Another solution would be to have the foreign country’s tax office report the amount of wages earned to the Internal Revenue Service which would then assess the appropriate employment tax on the foreign earnings. This solution, however, could have practical problems depending upon the computerization of the foreign country’s taxing system.

While there are drawbacks to this solution, qualifying the individual for Medicare would, in the long run, provide a great benefit to the individual which would outweigh the current inconveniences created.

B. Modify the 26 U.S.C. § 3121(l) Election

The 26 U.S.C. § 3121(l) election allows the U.S. employer to make an election to pay Social Security taxes for U.S. citizens and resident aliens working in a foreign affiliate. The current election only allows the employer to make the election, and the employer must pay both halves of the tax, which results in a disincentive for the employer to make the election. This is to the detriment of the employee.

The modification would be to allow either employer or employees (as a collective block), to make the election with the tax being paid one half by each in the same manner as Social Security taxation is handled for employees working for U.S. firms. This modification would not further increase administrative costs as the election already exists, and

173. Form 941 is a quarterly report filed showing the amount of wages paid to employees, as well as the amount withheld, date withheld, amount deposited, and quarter deposited. This information must agree with actual payroll tax deposits in order to avoid penalty assessment against the employer.


175. The collective block approach would be required to reduce administrative costs and complications to a minimum. The block could comprise a simple majority or two-thirds of the employees.
the employer is already subject to the potential administrative burden of paying the Social Security tax if the election is made. Nor would this modification provide an administrative headache for a foreign employer, as 26 U.S.C. § 3121(l) requires that it be a U.S. employer that makes the election and pays the tax, and not a foreign employer.\textsuperscript{6} This change would provide an advantage to the U.S. employer as she would now be subject to paying only one half of the tax as opposed to both halves. It would also provide the benefit of helping the U.S. employees to qualify for both Social Security benefits (assuming that they are in a country with no totalization agreement or no social insurance program) as well as Medicare benefits.

\textit{C. Modify the Tax Treaty}

In limited circumstances, the self-employed person under the tax treaty may not only be able to exclude self-employment income earned overseas, but the self-employment tax on that income as well.\textsuperscript{177} This provides a distinct competitive advantage over the self-employed individual performing the same work inside the United States. This discrepancy violates the principles of capital-export neutrality.\textsuperscript{178} In order to keep consistent with the U.S. position on international taxation, as well as level the competitive playing field for self-employed U.S. citizens everywhere, all self-employment income should be subject to self-employment tax regardless of where it is earned. Any cases of double taxation may be settled with the imposition of a credit on the foreign taxes as discussed previously.

This may provide a problem with compliance. How is the Internal Revenue Service to determine how much money a U.S. citizen working abroad was paid, especially if the payments were in cash? However, this is the same problem that the IRS already faces with self-employed individuals working inside the United States. Self-employment provides great opportunities for tax evasion, and, while ensuring compliance for overseas workers might be more difficult to enforce, it will be a similar problem to the one the IRS already faces.

The treaty should be amended to enhance the information-sharing agreements that already exist between treaty nations in order to help ensure compliance for self-employed individuals working overseas.\textsuperscript{179}

\begin{itemize}
\item \textsuperscript{176} 26 U.S.C. § 3121(l)(1).
\item \textsuperscript{177} See discussion, \textit{supra} Part II.B.2.b.
\item \textsuperscript{178} See \textit{GUSTAFSON ET AL. supra} note 97, at 17. Under capital-export neutrality, the investor/worker pays the same amount of tax regardless of where it is earned. The U.S. Treasury Department tends to favor this neutrality approach. See \textit{id.}
\item \textsuperscript{179} See 1996 \textit{U.S. Model Treaty, supra} note 115, art. 26, at 895.
\end{itemize}
This, of course, will depend upon the capability of the foreign country to provide such information about U.S. citizens working in its country to the Internal Revenue Service. Factors such as the record-keeping system of the foreign country's taxing department and the sophistication of its computer system play crucial roles in determining the success of this amendment.

The advantages of this program would be increased collections of taxes for the United States. Self-employment income is often excluded from any taxation by a treaty, so the United States would be able to assess the self-employment tax without a reduction due to a foreign tax credit. This would result in the tax being paid to the United States and not to the foreign country. As it is set up now, quite often, the tax is not paid to either country. Additionally, there is the benefit of helping the individual to qualify for Social Security and Medicare benefits.

**D. Modify the Internal Revenue Code**

A final proposed approach to correct disparities in the application of the Social Security tax to U.S. citizens working abroad would be to make changes in the Internal Revenue Code itself.

The Internal Revenue Code could be amended to enable U.S. persons who perform services outside of the U.S. (either as an employee of a U.S. person or as a self-employed person) to elect out of the U.S. Social Security insurance tax system for all compensation derived for services performed outside of the U.S.

This would accomplish several objectives. First, the U.S. person would not be in a position of having to pay into both the U.S. social insurance program and the foreign country's social insurance program (if it exists) and potentially not be eligible for either social insurance program.

Second, this treatment would enable these U.S. persons to be in a similar social insurance tax position as their U.S. counterparts who perform services overseas as an employee of a foreign company.

Third, since all services are performed outside of the U.S. (and maybe the focus of that person's personal and business life is outside of the U.S.), the U.S. government presumably has less interest in assuring the individual is paying into the U.S. Social Security system.

Fourth, the small number of U.S. individuals who elect out of the U.S.

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180. Practically speaking, amendment of a tax treaty is very difficult. Both countries must desire the amendment, the U.S. Congress must approve all amendments, and the Treasury Department must believe the amendment is warranted.

For example, for several years, there has been a significant industry lobby to amend the U.S.-Japanese treaty. The proposed changes are supported by the Treasury Department, and no complaints have arisen in Congress or the Presidency concerning the changes, yet the treaty remains unchanged and appears unlikely to change in the near future.
Social Security system would presumably be small (relative to all contributors), and, therefore, would probably have a negligible impact on the tax revenues of the Social Security system. This would make it politically more acceptable.

Finally, the U.S. person would be in the best position to analyze whether they would personally be better off to elect out of the U.S. Social Security tax program; since they would be able to determine their eligibility (and amount of benefits) in the foreign country's social insurance program.  

IV. CONCLUSION

The laws governing taxation of social security for U.S. citizens working abroad are very complex and can result in great discrepancies in the individual's tax liability due to minor changes in her working status. This is a double-edge sword: while it provides great opportunities for tax planning, it also provides pitfalls for the unwary that may result in unpleasant surprises, some of which will not even materialize until after the individual has retired and is applying for Social Security and Medicare benefits. The changes suggested by this Comment are not designed to eliminate the planning opportunities, but rather to remove some of the more drastic pitfalls.

MICHAEL P. LEWIS

181. Letter from Patrick W. Martin, Partner, Procopio, Cory, Hargreaves & Savitch LLP (on file with author).