ARE EXPATRIATES REALLY THAT EXPENSIVE?

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Multinational enterprises setting up operations in Central and Eastern Europe are sometimes surprised to discover how costly social security levies in the region can be. In fact, they are often as significant, if not more so, than corporate taxes. But proper planning beforehand may help reduce the impact of these levies.

Multinational groups are becoming increasingly concerned about the costs associated with seconding an expatriate to their Central and East European operations. The reasons for the escalating expenses are rarely associated simply with the remuneration which employers are required to pay their 'expats' – it quite often has as much to do with the indirect costs of employment, such as payroll taxes, unemployment insurance levies and social security contributions. While many of these costs also impact on local employees, the relatively high salaries which expats attract (and the fact that most employment-related levies are based on a proportion of salary earned), makes employing secondees all the more expensive.

As Table 1 indicates, social security rates in Central and Eastern Europe are quite high and, in fact, are comparable to prevailing income tax rates in those countries. While a comprehensive analysis of the relative cost of social security levies in a host country in Central and Eastern Europe would require a review of the alternative costs of the home country system or of a privately-arranged insurance/pension (and, of course, of the relative benefit entitlements), the table over the page does give an indication of the magnitude of the potential cost.

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Table 1 – Social security rates in Central and Eastern Europe

	Social Security Contributions (%)		Top Marginal Individual Income Rate (%)
	Paid by Employer	Paid by Empolyee	
Albania	32.5	3	30
Armenia	30	1	45
Azerbaijan	37	1	55
Belarus	36	1	60
Bulgaria	35	0	50
Croatia	21	25.5	35
Czech Republic	35.25	13.25	44
Georgia	37	0	40
Hungary	49.3	11.5	44
Kazakhstan	38	1	60
Kyrgyz Republic	37	1	40
Latvia	37	1	35
Lithuania	30	1	33
Moldova	39	1	50
Poland	48.5	0	45
Romania	31	6	60
Russia	39	1	30
Serbia	23	23	40
Slovakia	38	12	42
Slovenia	22.45	22.45	30
Tajikistan	38	0	40
Ukraine	39	1	60

A significant impediment to understanding Central and East European social security systems is the fact that it is often difficult to obtain reliable technical information or government clarification with respect to social security levies. Some of the problems have deep historical roots. Social security regulations have not kept up with developments in income tax systems. In a number of countries, old communist-era regulations remain in effect. Although they have undergone ongoing amendments, these regulations are incompatible with other legislation and cannot handle issues associated with international movements of labour. In addition, social security authorities have little experience of dealing with foreigners and understanding their particular concerns. It is very easy to make costly mistakes by not knowing or misunderstanding the host country's systems. On the other hand, a proper understanding can reveal opportunities for cost saving.

In some cases, a careful review will reveal that expatriates are subject to only limited contribution. In other cases, one may discover that expatriates are entitled to no or only limited benefits from the system to which they must contribute. In addition, one must consider the possible income tax consequences, in both the home country and the country of assignment, of making contributions and receiving benefits under an applicable social security programme.

In considering the social security aspects of a secondment, one has to ask four basic questions:

- What are the possible costs that may arise?
- What benefits can the employee receive from the system of the host country?
- How can the social security costs be minimised?
- What are the possible income tax consequences in both the host and home countries of the social security plan adopted?

What are the costs?

This question is not necessarily as straightforward as it sounds. The following are just some of the possibilities to be considered.

○ Do expatriates have to contribute to the system at all?

If not, then the cost of seconding the expatriate can be reduced significantly. In some countries (e.g., Hungary), it is not mandatory for expatriates to contribute to the social security system. In other countries (e.g., Bulgaria), a reduced rate is applicable to expatriates.

○ **What programmes form part of the host country's social security system?**

A common mistake in calculating social security contributions is to assume that there is one rate applicable to cover all social programmes. For example, the above statement that expatriates do not have to contribute to the social security fund in Hungary could be misleading - expatriates can choose not to pay social security, but are required to make unemployment insurance contributions.

As well, in many countries a number of additional social funds which originate from the era of communist rule have survived to the present. These include such programmes as state run disability funds, recreation funds, and funds for war veterans. As well, mandatory insurance payments (like the work injury insurance premiums in the Czech Republic) may constitute a separate category of costs.

Strategies to minimise social tax

Even if one concludes that an expatriate would ordinarily be subject to all forms of social security contribution, careful planning may still help to minimise costs. The following are some possible approaches:

○ **Would a foreign employment contract help?**

In many cases, the scope of social security legislation is a good starting point for planning. In some countries (e.g., Poland and Russia), the rules cover income derived from a domestic employment contract – in such cases, using a foreign employment contract may offer an opportunity to avoid social taxes.

It should be noted that the income derived from offshore contracts could still be subject to income tax, either because the expatriate is resident in the host country and, therefore, subject to worldwide tax liability or because income earned in respect of an employment exercised in the host country will be subject to income tax. What is remarkable is that there can be situations where income tax is charged but social taxes are not!

○ **Try to reduce the taxable base**

Sometimes, in planning tax effective structures, insufficient attention is paid to reducing the taxable base for social security contributions. Although there is a growing trend in Central and Eastern Europe for countries to extend the social tax base to include fringe benefits and other non-cash compensation, there are still countries where this is not the case. Some countries (e.g., Albania and Moldova) do not treat benefits-in-kind as income and, therefore, the value of the benefits do not turn up in the taxable base. In other cases, specific types of benefits, like housing, relocation costs, school fees, company cars, are not included in the tax base. There might also be specific types of income, like certain royalty payments, preferential employee stock purchase plans or types of life insurance concluded for the benefit of the employee, which are either not covered or are expressly exempted by the social security legislation and which can be offered to the employee as part of his or her compensation package.

It is a traditional tax planning tool to structure the employee's compensation package in such a way as to shift a portion of total remuneration into non-taxable elements, and this strategy can also be used (even if income tax cannot be saved) to reduce the social security charge.

○ **Can contributions be reclaimed upon departure?**

Normally, contributions made to state funds are final, while contributions paid to private pension plans (in those few countries where this option is now available – e.g., Hungary and the Czech Republic) can normally be withdrawn when the employee is leaving the country. Before voluntary contributions are made, however, it is wise to examine whether contributions to a fund can be withdrawn and whether they can be transferred to a foreign fund without income tax liability arising. (Note also that foreign exchange problems may arise when transferring funds abroad.)

Weighing the benefits

Having examined the possible costs of social taxes, let us look at the 'other side of the coin' – the possible benefits offered by the host country's social security system and the benefits to be lost by not contributing to the system. In the desire to reduce costs it is often forgotten that the employee's ultimate concern is to ensure adequate coverage for himself and his dependants.

○ **Paid sick leave/temporary disability pay**

Insured persons are entitled to paid sick leave during their sickness and temporary disability pay during their temporary disability. Usually it is linked to a minimum period of insurance (in most cases 90-180 days) and to the opinion of a doctor. In the case where an expatriate is not covered by social insurance it seems advisable to ensure that the expatriate is covered by a private plan.

○ **Free medical care**

Central and East European social security systems cover full medical insurance, which usually means free medical treatment and heavily subsidised prescription drugs. The quality of the service, however, is not always satisfactory because of old and poorly equipped medical facilities. If an expatriate has private insurance (usually from the home country) he has to check whether the insurance is valid for use in the host country and whether it is accepted by the medical institutions of the host country.

○ **Family allowances/pensions/unemployment pay**

These are significant benefits of Central and East European social security systems, but are usually not available to expatriates even if they have to contribute to the relevant funds.

The hidden costs: additional income tax liability and double taxation

Normally, income tax complications do not arise when dealing with state programmes in the host country - contributions to the social security system by both the employer and the employee are deductible in all Central and East European countries and, in most countries in the region, benefits received are exempt from income tax (with the exception of pensions in the Czech Republic, Slovakia and Poland).

The above rule applies only to domestic pension plans. If, for example, a foreign employer pays contributions to a home country pension plan on behalf of the expatriate employee, the employee may be taxed on that benefit in the host country (if, for example, the employee is subject to worldwide taxation in the host country as a resident). Similarly, if an expatriate contributes to a pension fund in the home country, the contribution generally will not be deductible in the host country. The advantage of deferring tax liability by contributing to a pension plan is lost and some years later the payments made from the fund will be taxed in the home country.

Contributions to state social security funds may not be converted or reclaimed; they are lost when leaving the country. If an expatriate contributes to a private pension plan in the host country in the same way as local employees, no income tax liability arises on the contributions so the tax liability has been deferred to the end of the assignment. However, income tax liability arises under domestic laws when the expatriate attempts to withdraw contributed amounts. The tax liability cannot be eliminated by the use of a tax treaty, because none of the current treaties concluded by the Central and East European countries have provisions on benefits from pension plans. According to the general rules, pensions and similar remuneration received within 5 years after leaving the country are still taxable in the host country.

Are expatriates really that expensive?

Table 2 provides an example of the potential savings if an employer succeeds in exempting an expatriate secondee from liability to social security contributions in either Hungary, the Czech Republic, Poland or Russia. The table shows the total cost in terms of salary, income tax and social security contributions which must be incurred in order to leave an employee with 100 currency units of net salary. Please note, however, that we are only comparing the relative costs taking into account social security and income tax – there may be other payroll or salary related taxes which would have to be considered in an actual case. Russia, for instance, has a wage tax payable by the employer at a rate of 38% on an employee's wages in excess of a relatively low exempt amount, and also has a number of other minor taxes such as its education tax and housing tax.

In the example some simplified assumptions have been made: the individual income tax cost has been computed by using only the top marginal income tax rate; and only the total social security contribution costs (comprising health, pension and unemployment insurance premiums and including both employer and employee portions where applicable) are shown.

We also assume that both the local and the expatriate employees receive a net salary of 100 units (including in-kind benefits) and that the expatriate is employed under a foreign employment contract which covers employment entirely exercised in the host country. Of course, in reality expatriates are often able to demand higher salaries than their local colleagues.

The difference between the relative costs of expatriates and locals (or expatriates not exempted from the social security cost) is arrived at by using two simple planning strategies: the domestic job of the expatriate was covered by a foreign employment contract and in the Czech Republic and in Hungary the position of the expatriate was designed in a way that the expatriate qualified for the special income tax regime.

Table 2 – Income tax and social security costs: A comparison

	Hungary		Czech Republic		Poland		Russia	
	local	expat	local	expat	local	expat	local	expat
Top marginal income tax rate social security (combined employee and employer)	44% 60.8%	30.8% 0.0%	44.0% 48.5%	30.8% 0.0%	45.0% 48.5%	45.05 0.0%	30.0% 39.0%	30.0% 0.0%
Net salary	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Income tax cost	78.6	44.5	78.6	44.5	81.8	81.8	42.9	42.9
Social security cost	122.6	0.0	99.8	0.0	88.2	0.0	56.7	0.0
Total cost	301.2	144.5	278.4	144.5	270.0	181.8	198.6	142.9

What can we conclude from these numbers? First of all, that of the four countries Hungary's taxes and social contributions account for the largest proportion of total labour costs for local workers (i.e., it costs the Hungarian employer the most to get 100 currency units into the hands of the employee). Second, that exemption of an expatriate from social security has the most powerful effect in Hungary – under that assumption, it costs the employer about half as much to get 100 currency units into the hands of the expatriate. This gives the employer greater leeway to pay the expatriate the higher salaries that western executives expect – it can pay the expat twice as much in net salary and incur the same total cost as for the local employee. Third, it appears that expatriates are relatively cheapest in Russia (but don't forget those other payroll-related taxes mentioned above!).

Conclusion

The above are just some of the social security implications that need to be considered before an individual is transferred to Central/Eastern Europe. Planning of social taxes is an area which usually does not receive as much attention as income tax planning. We hope, however, that the above shows that an in-depth knowledge of social taxes combined with careful advanced planning may provide substantial benefits and safeguard the multinational group from costly miscalculations.