

SELECTED AREAS OF COST

Chapter 20 – Domestic and Foreign Taxes – Differential Allowances

Authoritative Sources

[FAR 31.205-6\(e\)](#), Income Tax Differential Pay

Tax differential allowances represent employee compensation for additional Federal, state, local, or foreign income taxes resulting from domestic or foreign assignments.

This chapter addresses the following topics:

20-1 FAR Applicability

20-2 Allowable Foreign Tax Differential Allowances

20-3 Unallowable Foreign Tax Differential Allowances – Contracts Entered Into Prior to December 31, 1996

20-1 FAR Applicability

For contracts entered into prior to December 31, 1996, under FAR 31.205-6(e), differential tax allowances for foreign assignments are unallowable if calculated directly on the basis of an employee's specific increase in income taxes. A specific increase is evidenced by any calculation that considers the employee's specific income tax liability, regardless of whether the calculation is made before or after the employee's actual taxes are known.

For contracts entered into on or after December 31, 1996, differential tax allowances for foreign assignments are allowable under FAR 31.205-6(e), even if the differential tax allowance is calculated directly on the basis of an employee's specific increase in income tax.

FAR 31.205-6(e) disallows any differential tax allowances for domestic assignments.

20-2 Allowable Foreign Tax Differential Allowances

A foreign tax differential complies with the FAR provision if it is a fixed payment to employees on foreign assignment, such as a \$3,000 annual payment, or if it is computed based on a percentage, such as 15 percent of all other foreign differential pay allowances.

Chapter 20

Separate foreign tax differentials based on marital status and/or number of dependents comply with the FAR provision. An example would be a payment of 15 percent of the total amount of differential pay for all married employees and 10 percent for all single employees. Another example would be a differential of \$3,000 for all employees, with an additional \$500 for each dependent.

20-3 Unallowable Foreign Tax Differential Allowances – Contracts Entered Into Prior to December 31, 1996

Foreign tax differentials based on the specific tax liability of a specific employee do not comply with the FAR provision in effect prior to December 31, 1996. For example, assume an employee has an estimated (or actual) tax liability of \$5,000. Further, assume that it is estimated that the tax liability would have been \$3,000 had the employee remained on domestic assignment. As a result, the employee receives a tax differential of \$2,000. This amount was computed based on the employee's specific tax liability and is therefore unallowable.

Foreign tax differentials based on the increase in the tax rate for a specific employee or employees do not comply with the FAR provision. For example, assume that there are three employees, each of whom is single with no dependents. However, because of differing investment income and/or itemized deductions, each employee has a different increase in his/her tax rate as a result of the foreign assignment. If the contractor computes the tax differential payments using 10 percent for Employee A, 12 percent for Employee B, and 14 percent for Employee C, the payments would be unallowable, since they are computed based on specific tax liabilities of specific employees.