Bloomberg Tax

Tax Management

International Journal™

July 23, 2024

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What Tax Changes Would Accommodate Employing Nomad Employees?

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Monique van Herksen of Simmons & Simmons discusses her personal perspectives on the tax changes needed to accommodate the employment of nomad employees.

Since the COVID pandemic, flexibility to work from a location other than the employer's designated office is a new-found highly valued freedom embraced by many employees. So much so, that corporates find that a flexible work policy is a must to retain and attract talent. Employers tend to be less enamoured with flexible work policies, and one area of concern is that when flexible working includes working physically in a jurisdiction other than that of the employer, it raises significant tax exposure and compliance concerns for those same employers. Other concerns include the challenge of companies' human resources departments providing consistency in the treatment of employees when some employees work remote and others do not. On the work floor, maintaining the corporate culture or fostering collaboration between employees may also be formidable.

The term "Nomad employees" comes with many interpretations. Korn Ferry, a global organizational consulting firm, refers to the "nomad economy," as an economy in which the number of jobs someone has in a lifetime will likely be double that of a generation ago. An increasing number of highly skilled employees are thus broadening themselves by taking on new professional challenges every couple of years, and are referenced as "career nomads" (Korn Ferry, *The career nomads have arrived*). That trend is also impacting how organizations that want to hire these employees should hire and retain them, so as to get the most out of them (Korn Ferry, *The Nomad Economy*). The cost of replacing high-performing career nomads for companies is estimated by Korn Ferry to be between 50% to 75% of their annual salary – assuming they can find a suitable candidate in the war for talent.

Digitalization provides for a technology-enabled lifestyle and allows employees who can perform their jobs digitally the flexibility to work remotely without the need to go into an employer's office. This means they can work from their home, or even travel and explore while working from another country.

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Fully remote work is typically made available by web design and digital marketing companies, information technology and services companies, software companies, online administrative service providers, and internet companies. But more and more, employees of service providers that traditionally would have been office-based, such as providers of financial, accounting and legal services, are opting for working flexibly and remotely. Essentially, people who embrace a location-independent, technology-enabled lifestyle have moved from eccentrics to mainstream in less than a decade and are commonly referred to as "Nomad employees" (MBO Partners, *2023 Digital Nomads Report: Nomadism Enters the Mainstream*).

For the employing companies, tax challenges resulting from the nomad working trend fall roughly into two categories: corporate tax challenges and wage withholding tax challenges. Income tax provisions for employees are not addressed as such in this article.

Tax Challenges

The corporate tax challenges regard the employing company's own corporate tax obligations and the wage withholding tax challenges regard the company's obligation as an employer to withhold wage tax and social security for its employees under the applicable laws. Noncompliance with these provisions or underreporting/underpayment of taxes is likely to lead to penalties and assessments for the employer. This is highly undesirable, costly and to be avoided. Unfortunately, the currently applicable tax rules have been designed without considering the rise of Nomad employees.

While some companies are demanding that employees return to working from their offices (and others even suggest implementing higher pay for employees working out of the office to lure employees back in), if remote working is here to stay, some constructive solutions should be implemented to address the mentioned tax challenges (Tim Smart, Remote Work Has Radically Changed the Economy – and it's Here to Stay, U.S. News (Jan. 24, 2024)). Some practical solutions that could serve to provide companies some relief and make it easier for them to accommodate requests by employees to work remote in another jurisdiction are suggested below.

Corporate Tax Challenges and Permanent Establishment

The corporate tax challenges mainly regard the employer having a "permanent establishment" (PE) in the country where the Nomad employee is physically working. The existence of a PE triggers the obligation to file a corporate income tax return in the country where the PE is located and allocate taxable income to that PE. The presence of a remote working or teleworking employee in a country becomes a PE in case that presence becomes a "place of business." However, for that the location ought to be "at the disposal" of the enterprise according to Article 5 of the OECD Model Convention that regards PEs. For a home office to constitute a place of business, it has to be at the disposal of the foreign employer. Generally, the mere execution of the employee's activities from his home office should not automatically lead to the conclusion that the home office is at the disposal of the foreign employer. It will depend on the actual circumstances and activities.

PE Facts and Circumstances. A remote working employee's home in a foreign country is usually not at the disposal of the employer. Facts and circumstances may lead to another conclusion if, for example, the employee is required by the employer to work from home (i.e. no office space is made available) and the home office is used on a continuous basis. To pre-empt overly theoretical analyses on this,

making clear that hybrid working policies (i.e., where employees are allowed to work from home three days a week and required to be in the office two days a week) should not be considered as a "requirement to work from home" would help. If, furthermore, the employer tries to reduce cost by subletting or cancelling excess office space, that still should not be considered a "requirement to work from home" in the jurisdiction where the employee is physically working. This is merely a reaction to the employee demand for hybrid working arrangements by the employer. Including this particular point of view in the Commentary to Article 5 ("the PE Article") could already help avoid overly theoretical analyses and the creation of many micro PEs.

Furthermore, it merits mentioning that the question as to whether working from home becomes a PE has been addressed by using a percentage of time working from home test in some bilateral agreements. For example, in the 2023 bilateral agreement between the Netherlands and Belgium, the countries agreed that employees teleworking less than 50% of their working time would not lead to a PE. The agreement includes that incidental working from home and voluntary working from home does not rise to the level of a PE (*See* (in Dutch) Staatscourant 2023, 33856 | Overheid.nl > Officiële bekendmakingen (officielebekendmakingen.nl)). A similar percentage threshold test could be included in the PE Article to create another objective test as to whether the PE threshold is met or not.

PE Article Preparatory or Auxiliary Exemptions. The PE Article provides for exemptions, clarifying what activities would not constitute a PE. For example, an exemption applies if the activities performed at the place of business have a "preparatory or auxiliary" character. In that case, they should not lead to the existence of a PE. Whether activities qualify as such will depend on the type of business of the employer, however. Internal accounting services, internal human resources services, or internal ICT support provided by a remote working employee to support the employer's business would normally qualify as preparatory or auxiliary services. Clarifying this explicitly in the Commentary to Article 5 may be helpful.

PE Article Personal Purposes Exemption. The majority of requests to work remote from a foreign country tend to involve employees requesting such for strictly personal reasons. There usually is no employer business purpose for the location from where the employee is working whatsoever. If anything, the employer would probably have preferred the employee to work physically from the employer's office. While the absence of business reasons to be somewhere does not make activities performed preparatory or auxiliary, the absence of business reasons for the choice of location should be considered an important fact. Combined with other factors, such as the employee's home or working location not being available for the employer, and the employee not prospecting local business in the location where the employee's business is conducted leads to the opportunity to create a new 'personal purposes exemption' from becoming a PE.

Micro PE Safe Harbour. Another type of PE is the one resulting from the presence of a dependent agent. That would include an employee with authority to conclude contracts and do business on behalf of the company of the employer in the country where he or she physically works and who habitually exercises that authority. An employee tasked with negotiating contracts on behalf of the employer and who habitually does so, will trigger a PE when working remote from another jurisdiction, even if the remote work location is picked strictly for personal purposes. In that case, and when the personal purposes exemption test suggested above is flunked, it would greatly help if a simplified or safe harbour approach is made available to calculate what income would be allocable to the (micro) PE. Such a simplified or safe harbour approach could look somewhat like this:

If and to the extent a remote working employee is determined to be a (micro) PE, the income allocation method to be used for that (micro) PE is determined by:

A. In case the employee's functions considered in comparison to those of the employer's company as a whole —when accurately delineated — qualify as a "low value adding service," as defined in the EU Joint Transfer Pricing Forum's proposed guidelines on low-value-adding intra-group services, that regime may apply to the (micro) PE for purposes of determining the income allocation to the (micro) PE (European Commission, *Communication from the Commission to the European Parliament*, The Council and the European Economic Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals (Jan. 25, 2011));

B. Alternatively, the transfer pricing analysis and characterization that applies to the division, unit, or department for which the employee is working, or of which the employee is a member, can be applied on a proportional basis. In other words, if the division, unit or department for which the employee is working is characterized as rendering services and remunerated at arm's length using a Transactional Net Margin Method (TNMM) with as profit level indicator return on total costs, the same approach could apply for the (micro) PE, provided the appropriate (proportional) cost are used; or

C. If the employee functions do not qualify as low value adding services, or if no transfer pricing analysis exists for the specific division, unit or department for which the employee is working or of which the employee is a member, or that analysis would be pertinently inaccurate for other persuasive objective reasons, another solution is needed. In that case, perhaps the micro PE's income allocation might be based on the transfer pricing analysis and characterization that applies to the employer's company as a whole — if there is one (again on a proportional basis).

What happens when a Nomad employee physically working in another jurisdiction ends up using the office of a local subsidiary occasionally? Would this taint the functionality of the local subsidiary from a transfer pricing perspective? Based on the assumption that (i) there is no business purpose for the employee to work in the jurisdiction, and (ii) such office use is occasional and not structural, it would be unlikely for those activities to taint the transfer pricing analysis of the local subsidiary. To the extent the employee's activities rise to the level of a (micro) PE, income allocation along the lines of options A-B-C above should suffice and assure an arm's length income allocation to the (micro) PE. While purists may emphasize the need for a deep-dive development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis as regards the function and activities of the Nomad employee, such an analysis is not likely to lead to a material increase in the income allocation to the (micro) PE. Yet the costs of such an analysis would likely operate as a restriction for employers to compete in the war for talent and accommodate Nomad employees working from another jurisdiction.

Wage Withholding Tax Challenges

The wage withholding tax challenges include the employer's obligation to withhold and remit monthly wage withholding and social security payments to tax authorities from the employee's gross monthly income. To the extent those wage withholding payments are made to the tax authorities in the country where both the employer and the employee are resident and the employee is working, no problems arise. When at year end, the employee files an annual income tax return, the wage withholding payments made by the employer will be applied against the employee's income tax liability.

When an employee is working and resident in another jurisdiction than that of the employer, wage withholding payments made by the employer to the tax authorities of its state of residence will not automatically serve to offset the employee's tax liability in the jurisdiction where the employee is working and resident. To correct for this, assuming there is no income tax liability for the employee in the country of the employer, the prepaid wage withholding tax needs to be refunded (to the employee) so that the employee is made whole and can pay his or her income tax liability in the state where he or she has been working and is resident.

Seeking a waiver from having to make wage withholding tax payments to the tax authorities in the jurisdiction of the employer is governed by local law, and not addressed in tax treaties. At the same time, an employer may be violating the applicable rules in the country where the employee is resident and working by not making monthly wage withholding tax and social security payments to the tax authorities there.

Article 15 of the OECD Model Convention allocates employment income (in full) to the state of residence of the employer so long as the employee is present in the work state for less than 183 days in the aggregate in any 12-month period beginning or ending in the fiscal year concerned, the remuneration is paid by or on behalf of an employer who is not resident in the work state and the remuneration is not borne by a PE of the employer in the work state. If any of these three conditions are not fulfilled, the work state may tax the salary of the employee.

Clear, Pragmatic Process for Waiver, Collection, and Refunds. To accommodate Nomad employees and reduce tax challenges, employing companies would benefit from (1) clarity on the process and information required to be filed to obtain a waiver from wage withholding obligations in the state of residence of the employer; (2) the availability of a pragmatic process for the employer (direct pay would be preferred) to meet wage withholding and social security obligations in the state of residence of the employee (assuming this is a jurisdiction different from that of the employer); and (3) swift refund procedures of taxes and premiums paid for employees for which wage withholding payments were made in the "wrong" jurisdictions.

A more structural and ideal solution could be that the employer would remain the primary party responsible for wage withholding and social security payments during a calendar year, *regardless* of where the employee is working or resident. After year-end, there may be a need for tax authorities to settle the tax liability between them in case those payments ought to have been allocated to the country of residence of the employee. If a bilateral tax treaty applies between the respective jurisdictions, Article 15 could be updated by including a reference to such a process. This could be done adjacent to an obligation for the employer to annually file detailed information on their employees' residence and physical place of work.

Employment Agencies or Payroll Providers. To circumvent the wage withholding tax challenges mentioned, many employers make use of employment agencies or payroll providers in countries where their employees end up working and / or residing. Those employment agencies or payroll providers take on the tax compliance obligations of the original employer. Unfortunately, this solution comes at a cost for employers and has its own set of challenges, one of them being that the original employer can be considered the "economic employer" and the payroll provider essentially ignored, leading to double tax liabilities for their employees.

What's Next?

Korn Ferry concluded in their Study called "the Future of Work" that a global talent crisis could cost nations trillions of dollars in unrealized annual revenues. Unrealized annual revenues are untaxed annual revenues. The talent crunch—an imminent skilled labour shortage affecting both developed and developing economies—should wake up governments, including their tax authorities, that urgent action is required to secure their tax base in the long run. A way to do so, is to accommodate employers to recruit and retain talent that wants to work remotely from another jurisdiction. Resolving the identified tax challenges will contribute greatly to that objective.

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