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Remote Work Arrangements Opens Taxation Traps for the Unwary

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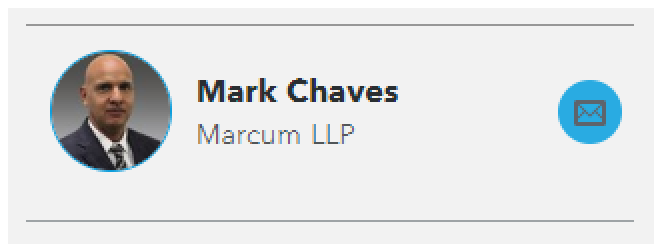
The spike in remote working arrangements since the beginning of Covid-19 has exacerbated cross-border taxation considerations, and employees and employers need to scrutinize them now more than ever, says Marcum LLP's Mark Chaves.



The pandemic has led a significant portion of the global workforce to opt for working remotely. Without the need to report to a particular office every day, employees are taking the opportunity to work in different countries. What better way to achieve work-life balance than to boot up your laptop in the country of your choice, allowing you to be closer to family, or taking the opportunity to experience something different than would otherwise have been feasible?

I would venture to say that when folks envision their ideal remote work location, taxation is not top of mind. This is quite understandable, as their employer, salary, and manner of compensation will not change, so a change in tax status may not be obvious.

From a tax point of view, however, working in a different country can have significant consequences for both the employer and the employee.

Employee Issues

Many countries tax income based on where services are actually performed. Thus, even though an employee may be receiving their wages from an employer in one country, the employee's new resident country may seek to tax any income earned while performing work services there.

Additionally, many countries treat an individual as a tax resident if that individual is physically present in the country for a certain number of days in a given year. The United States, for example, treats an individual as a tax resident based on a three-year formula known as the substantial presence test. If, under this formula, the individual's cumulative presence over a three-year period equals or exceeds 183 days, they will be considered a US tax resident. This will subject the individual's worldwide income to US taxation and may lead to a myriad of required disclosures, many with substantial penalties if compliance requirements are not met.

The US, like many jurisdictions, will grant an income tax credit against a taxpayer's US income tax for income taxes paid to another country, known as a foreign tax credit. The US will grant a foreign tax credit for foreign income taxes paid or accrued to a foreign jurisdiction to the extent that the income is deemed foreign-sourced.

As it relates to salary or services income, US tax law sources income to the location where services are performed. As a result, if a US taxpayer performs services in a foreign country, the related income is deemed foreign-source income for US tax purposes, even though the individual may be paid by a US employer.

Another issue not often considered is social security taxation. Social security taxes may need to be paid in the country where services are rendered, especially if the employee works in that country for more than a certain number of days in a given year.

The US has entered into totalization agreements with various other countries that address the issue of social security taxation and stipulate which country has the right to collect social security taxes, depending on the jurisdiction of the employer and the length of time the employee will be working in a particular country. Employees working in a country that does not have a totalization agreement with their home country may find that social security or similar taxes are due in two jurisdictions.

Employer Issues

Depending on the functions performed, employee services rendered in-country may subject a foreign employer to taxation in that country, as the employee's presence may give rise to a "permanent establishment." The concept of a taxable, permanent establishment exists in many countries and bilateral income tax treaties, and may subject a portion of an entity's profits to taxation in a country where it has a permanent fixed presence. An employee working continuously in a country is often deemed to give rise to a permanent establishment in that country.

In May 2022, the Danish tax agency ruled that a German company had a permanent establishment in Denmark under the Germany-Denmark tax treaty, by virtue of an employee working at home in Denmark. The ruling stemmed from a prior ruling in October 2021, when the Danish tax authority refused to confirm that no permanent establishment existed where a foreign company employed a sales representative working from home in Denmark carried out sales activities for customers in countries outside of Denmark.

Once an entity is deemed to have a permanent establishment in a country, the entity will need to determine how much profit, if any, should be attributable to that permanent establishment for purposes of reporting and paying income tax. For example, if an employee regularly concludes sales contracts on behalf of an employer, a portion of the entity's profit generated by those contracts can be attributed to a permanent establishment and taxed accordingly.

An employee who performs back office functions on a regular and continuous basis in a country may also give rise to a permanent establishment in that country. However, the amount of income or profit attributable to the permanent establishment may not be as significant as sales activities. For example, back office services generally require a markup—typically of 5% to 10%—above costs to determine the profit attributable to such services.

Employers with employees working in another country will need to assess the need to register for payroll tax purposes in that country. It is often the responsibility of the employer to determine whether payroll-withholding requirements exist, in which case the employer will need to withhold income and employment-related taxes from the

employee’s pay and remit the appropriate amounts to the country’s taxing authority. Failure to do this can lead to interest and penalties.

Cross-border income and payroll tax issues have been a factor for companies operating internationally for many years. However, the recent spike in remote working arrangements incited by the Covid-19 pandemic has exacerbated cross-border taxation considerations, the impact of which need to be thoroughly scrutinized by both employees and employers, now more than ever before.

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