WHERE IN THE WORLD IS MY BUSINESS?

TAXABLE PRESENCE AND THE GLOBAL START-UP

BY JEANNE GOULET, CPA

MP&S Marks Paneth & Shron LLP
Certified Public Accountants & Consultants

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You Are Here – Or Are You? The Location of Your Business is a Critical Tax Issue

But each of these actions can trigger serious tax consequences, and greatly increase your exposure to the risk of double taxation. **Plotting your business strategy without keeping a close eye on taxation invites a high tax bill, and the possibility of penalties if you cross a tax threshold. And you can easily cross that threshold – inadvertently and unknowingly – simply by making routine decisions about where to conduct business and where to deploy staff.** Tax laws are complex, and you can easily put yourself at risk.

The problem for global entrepreneurs is this: While global business has become effectively geography-independent, tax remains stubbornly geographic. All over the world, in practically every jurisdiction, taxes are assessed based on the physical location of a business or a transaction. This has been the case for millennia. Throughout history, business transactions have been taxable in the place where they happen, and the business itself typically pays taxes where it "sits."

The key concept in determining the tax exposure – and the resulting tax strategy – for a business is called "taxable presence." The central question is this: Does a business have a taxable presence in a given location or not? The answer is determined by several factors, all of them related to the amount and kind of activity that a business conducts in that location, and the level of assets it maintains there. Taxable presence has implications, not only for global businesses, but for U.S. interstate businesses as well.

So, while from a business standpoint, it's clearly a small world after all, and there are many reasons to set up activities overseas, the tax picture can be daunting. Even a simple, desirable-seeming business decision can be fraught with tax consequences. It can seem appealing to send employees abroad to spend time in some of the world's technology hubs to get to know the culture in a target market while they do some software design and coding on site.. Such a move, however, creates tax issues – affecting the tax status of the employees themselves and creating tax consequences for the business. When intellectual property is involved, especially if it is of high value, things get even more intricate, as the question arises as to where the income from these intangibles will be taxed.

To avoid unpleasant surprises, **both a venture and its individual founders and employees must carefully assess where a business activity might constitute a taxable presence – and whether a taxable presence is really needed in a given location. They need to structure their entity and its activity to minimize double taxation.** Failing to do so can create a tax burden. And there are other consequences. Upon a future sale of shares of a company, it is not unusual for the purchasers to require that the seller set aside funds in an escrow account to cover potential tax liabilities arising from taxable presence issues.

Planning an international tax strategy is not something an entrepreneur can readily accomplish unassisted. Any global entrepreneur contemplating a cross-border business move – whether the borders are States or Countries – should consult with a tax professional to understand and make adjustments for the possible tax implications.

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The Most Basic Question is How to Define Taxable Presence

What makes geography-related tax questions so complex? Consider the ins and outs of even the most straightforward question, namely, what constitutes taxable presence in a jurisdiction?

The answer depends on how much of a presence or how much activity is needed before it's considered a taxable presence. You can visualize the concept of taxable presence in terms of a "threshold." Once you exceed the threshold by a certain quantity and/or quality of activity, you've achieved a taxable presence in a jurisdiction.

Thresholds come in different "heights". The lower the threshold, the more easily a business can find that it has – perhaps inadvertently – established a taxable presence:

- **Nexus.** Does the business represent a "nexus of activity" in a given place for the purposes of taxation? This, a state-level test, is one of the lowest thresholds, one which a start-up can easily cross with just a minimal level of activity.

- **Income Effectively Connected with a U.S. Trade or Business.** Does the business generate enough income to pass this test? This is a slightly higher threshold that applies to federal tax.

- **Permanent Establishment.** Does the business constitute a permanent establishment in a given location? This is one of the highest thresholds. It is an income tax treaty concept that applies to cross-border transactions.

Understanding these thresholds – and knowing which activities put a business "over the line" – is extremely important.

State Tax Nexus is the Easiest Tax Threshold to Cross

The word "nexus" means a connection. The term "tax nexus" suggests that a business has enough of a connection to a state that it is subject to state taxation. Nexus, a state-level threshold, applies to either state income and franchise tax or to the duty to collect sales or use tax. Its key features are:

- **It is defined by state statute, case law or regulation.** Because of this…

- **There are different definitions of nexus for each state and for different types of taxes imposed by a state.**

And as a result of these complex, overlapping definitions, it is entirely possible for a start-up's tax obligations to vary from one state to another. For example, it might be liable for the collection of sales tax but not for the payment of income tax in a given state.

Federal law complicates the matter still more. **The federal government has established that certain activities are off limits and cannot be taxed at the state level** as they interfere with interstate commerce. Such activities fall under Public Law 86-272 which prohibits a state from imposing income tax if:

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- The only connection to a state is the solicitation of orders of sales of tangible personal property and

- Such orders are accepted and shipped or delivered from outside the state.

Note that this definition excludes real and intangible property, the latter being of special interest to domestic or global start-ups.

The limitations on a state's rights to tax are obviously intricate. And the concept of taxable presence on the state level has been rendered even more so thanks to the Internet. Concerning this: On occasion, the U.S. Supreme Court has ruled on matters of state taxation on the basis of U.S. constitutional issues (such as the concept of due process and the commerce clause – these concepts limit states' rights to tax). A landmark case is Quill Corp. v. North Dakota, where the Supreme Court ruled that a business must have some physical presence in a state in order to be required to collect the state's sales/use tax.

Not surprisingly, the Quill case has been at the center of debate in the e-commerce arena, where out-of-state merchants are eager to avoid charging their customers local sales tax, and hard-pressed states are equally eager for the revenue.

A New Set of Tax Liabilities is Created by the Federal Standard of "Income Effectively Connected with a U.S. Trade or Business"

Next up is this intermediate Federal-tax threshold, which applies mainly to global start-ups headquartered outside the U.S.

Under U.S. tax law, the concept of "income effectively with a U.S. trade or business" generally depends on whether activities by foreign taxpayers and their agents in the U.S. are continual, and whether they generate a profit.

The definition of what constitutes "trade or business" is unclear. Generally speaking, the test for determining if income is connected with a U.S. trade or business requires an analysis of the following:

- **The asset test:** Does the business warehouse inventory at a distributor located in the U.S., including consignment inventory? Are other significant assets maintained in the U.S.?

- **The agency/relationship test:** Does the business use an agent who has authority to sign contracts which he or she exercises on a continuous or regular basis?

- **The activity test:** Is inventory sold on a regular basis in the U.S.? Are products demonstrated and are orders solicited even if the entity has no U.S. office? Is merchandise in the U.S. inspected on a regular basis? Does the business perform personal services in the U.S. (such as a single performance by a visiting entertainer or athlete?)

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As for the consequences: A non-resident individual or corporation that passes this test, and is determined to have income effectively connected with a U.S. trade or business, is taxed on U.S. net income as though he, she or it was a U.S. resident or corporation. If, on the other hand, it is determined that there is no trade or business, then a non-resident is taxed at a 30 percent rate on gross business and non-business income (dividends, interest, rents, royalties etc.), unless a lower treaty rate applies. The difference can be significant.

The Highest Level of Complexity is Represented by the Treaty Concept of Permanent Establishment

Finally, we come to one of the highest thresholds – one that will allow the greatest amount of activity in a country before the business becomes subject to tax. It is defined in bilateral income tax treaties as "permanent establishment." This sets a higher test for tax liability. It says that normal business activities are not enough to expose a business to taxation in a given country. It must also have a "permanent establishment" in that country. Some countries apply this standard even where a bilateral tax treaty is not applicable.

Treaties are extremely individualized. Treaty provisions generally take precedence over the local country tax laws. Beyond that, because so many variations and nuances exist, each bilateral treaty must be examined individually.

There are prototypes that provide a starting point for interpreting tax treaties. In the U.S., the starting point for negotiations with other countries is the U.S. Model Treaty. In a number of other countries, to minimize controversy and to create an international consensus on the taxation of business profits, the Organization for Economic Cooperation and Development (OECD) has created a prototype for bilateral treaties in its "Model Tax Convention on Income and on Capital" including its Commentaries. Both of these models tend to favor capital exporting countries. Then there is the United model tax treaty, which is intended to be used between developing and developed countries. The U.N. Model generally favors capital importing countries.

Although these models do have some fundamental differences, many similarities exist and these models are continually revised as both legal and business matters evolve. Ultimately however, each bilateral income tax treaty is unique and its provisions apply to residents of the treaty jurisdictions.

The purpose of these treaties, in general, is to limit tax liability and avoid double taxation. But there are traps, generally related to the challenge of defining a permanent establishment. What constitutes a permanent establishment? The definition, which varies from treaty to treaty, illustrates the intricacy of tax treaty provisions. For example, Article 5 of the OECD Model tells us, among other things, that:

- Permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
- The term includes:
    - A place of management
    - A branch
    - An office

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- A factory
- A workshop
- A mine
- A building site or construction or installation project, if it lasts more than 12 months.

But it also tells us that "permanent establishment shall NOT include items of a preparatory or auxiliary character," such as a warehouse, a showroom, a stock of goods that someone else will sell, a purchasing or information-gathering office. But if you have a "dependent agent" who can conclude contracts in the name of your business, you DO have a permanent establishment. But if your agent or broker is independent, you do not.

Because the definition of permanent establishment is all encompassing but for a limited number of exclusions, it is very easy for an enterprise to accidently slip into the status of a permanent establishment if it has employees working in its behalf in a foreign country. Determining whether or not this is the case depends on interpreting detailed treaty provisions, and the answer might not be "black and white." But **with proper tax planning and correct structural decisions concerning the role and the relationship between the foreign enterprise and the employee, the risks of tax exposure can be minimized.**

A few real-world examples illustrate circumstances that you need to avoid and show how, inadvertently, a foreign enterprise can cross the threshold and inadvertently create a permanent establishment in another country:

Case 1

An overseas business allows its software developers, regularly and for an extended period of time (with temporary interruptions), to use an office in the U.S. headquarters of another company or an affiliate in order to carry on business activities such as, software design, development or coding on behalf of the enterprise. These activities may constitute a permanent establishment, and the foreign enterprise may also be deemed to be doing business in the U.S. under the U.S. Statutory law. Therefore, this activity would subject the enterprise to tax in the U.S. on the income attributable to the permanent establishment or the trade or business performed in the U.S.

Case 2

A foreign enterprise has a server located in a foreign jurisdiction, which houses their website. This server could qualify as a "fixed place of business". If the website is carrying on business activities (such as e-commerce) at the location, which upon analysis are found to be "core functions" and not preparatory or auxiliary activities, then a permanent establishment might exist in the foreign jurisdiction, even if no employees are present. In this case, the enterprise would be subject to tax in the foreign jurisdiction on the income generated by the activity performed on the servers.

Case 3

An overseas employee does coding at home. As the OECD commentary explains, it is not necessary that there be a "traditional" office/fixed place of business for a permanent

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establishment to exist. A person working at home on a website or developing software can be considered to be a permanent establishment. This was the conclusion reached by the U.S. Tax Court in the case of Georges Simenon, the famed Belgian author of the Inspector Maigret mysteries, who was working from his home (44T.C.820 (1965)). As a result of the permanent establishment, the royalties Simenon received from the sale of his book were taxable in the U.S.

Further, if an employee of a foreign enterprise inadvertently creates a permanent establishment in the U.S. and is developing intangibles, serious tax consequences could result for the enterprise. The U.S. would require that the enterprise report the income generated by the permanent establishment and pay tax on the income resulting from the intangibles developed in the U.S.

The risks of potential tax liabilities for a foreign enterprise with employees working in another country are substantial. Again, they can be mitigated by careful advance planning. By structuring the mission and the relationship between the employees and the enterprise, and by properly documenting the relationship with an intercompany agreement, bad outcomes can be avoided.

Founders and Employees Also Need to Ask a Personal Question: Should I Become a U.S. Tax Resident?

Just as it's necessary to make critical strategic decisions for the business, the founder/CEO, fellow owners and employees must make individual decisions, including whether to become a tax resident of a particular country.

In the United States, start-up founders, owners and employees may choose to become U.S. tax residents after weighing the alternatives:

- Taxation on a worldwide basis on their net income, or…
- Taxation only on their US source income on a gross basis.

Just as a company can decide its jurisdiction, an individual who arrives in the U.S. may elect to be treated as a resident. That individual would therefore be entitled to be taxed as a citizen, with deductions and credits. Taxation as a U.S. resident may result in a more favorable outcome than taxation on gross income, provided that the individual's income from worldwide sources is negligible.

Conclusion:

In the Internet era, geography may not matter in business – but it does when taxes are concerned. "Taxable presence" – the concept of where you do business – determines tax liability at the state, U.S. and international level. The rules governing taxable presence are complex and very difficult for non-specialists to interpret. It's easy to create costly tax exposures accidentally, simply by making routine-seeming decisions about where to conduct business activities and where to deploy staff.

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To plan effectively and avoid these taxation risks, founders of global start-ups need to understand the idea of taxable presence, and make key structural decisions in order to optimize tax exposure. The assistance of a tax advisor or attorney – one well-versed in the details of state, U.S. and international tax laws and treaties – can help guide the entrepreneur and the business through the thicket of geography-based taxation and toward an optimal tax picture.

For more information or to set up an appointment with a team of MP&S specialists, please contact **Jeanne P. Goulet, CPA, Senior Tax Consultant** at MP&S at 212.710.1816 or jgoulet@markspaneth.com.

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