

MULTISTATE AND FEDERAL

Telework Taxation Uncertainties Remain As States Begin to Reopen

by Paul Jones

With states moving to reopen from COVID-19 lockdowns, businesses continue to face uncertainty regarding the tax consequences of employee telecommuting during the pandemic.

Tax experts and practitioners say states should provide clear guidance — and some accommodation — for employers facing issues created by their employees' atypical work locations during these times, including nexus in new states and potentially complicated withholding and employment tax obligations. Meanwhile, experts say that employers should move sooner, rather than later, to identify any potential tax obligations they have been exposed to by telecommuting workers.

Because of the pandemic, employees who live in one state and normally work in another have been working out of their home states, and “you might also have someone who goes to live at home with family in a different state, even across the country,” according to Jared Walczak of the Tax Foundation.

As a result, “nexus is going to span across all different types of taxes,” said Stephanie Do of the Council On State Taxation.

Some states have provided waivers and special guidance regarding telecommuting during the pandemic, but experts say that many taxpayers still lack clarity as to whether the presence of telecommuting employees will be treated differently than in normal circumstances — both for the duration of state shutdowns and after those orders are rescinded.

“We’ve only seen guidance from about 10 or so states,” said Pilar Mata of the Tax Executives Institute. “What taxpayers need is certainty if they’re required to do withholding, or if their employees create nexus.”

Some experts say the issue — and a possible long-term increase in telecommuting triggered by the pandemic — might even spur renewed interest in federal legislation to standardize state rules for nexus and withholding, or increase pressure on states to modify their rules. “What

COVID-19 has done is exacerbated the complexities with the multistate withholding system, and brought it to light,” said Charlie Kearns of Eversheds Sutherland (US) LLP.

New Nexus

The implications of having employees telecommuting from different states for a protracted period of time may be significant for some businesses. Having property or employees in a state for weeks or months can clearly establish a business's nexus with it for business activity tax purposes.

“We all know that physical presence does meet the threshold,” Do said.

Walczak noted that a single employee can establish nexus in a new state.

“Any payroll in a state can be sufficient — even one employee moving to a state could be enough, with an aggressive enforcement effort,” Walczak said. These rules aren't always strictly enforced, but with many employees telecommuting for weeks or months, “some states could see an opportunity to go after employees and businesses.”

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Employees can also establish a company's nexus with “local jurisdictions that have their own gross receipts tax or income tax” such as Portland, Philadelphia, and New York City, said Elizabeth Pascal of Hodgson Russ LLP.

Walczak said businesses that could be particularly impacted by COVID-19-related telecommuting are sellers of goods with sales in states where they have no other presence or activity apart from soliciting sales. Such businesses are in theory protected under P.L. 86-272 from paying those states' income taxes. But if an employee has been working in such a jurisdiction during the pandemic, “the state would have a stronger claim to say nexus has attached, and all of that sales income is taxable,” he said.

There are “a lot of corporations that only sell [tangible personal property] and only have a physical presence in a few states,” Walczak said.

A potential concern for remote retailers is that telecommuting employees could establish physical presence, and thus nexus for the seller in a state where its annual sales are below the jurisdiction’s remote sales tax compliance threshold. That would create a new sales and use tax registration, collection, and remittance requirement for the business.

Remote employees could also change a business’s corporate income tax apportionment in states that use payroll as an apportionment factor, which could be an administrative headache, Walczak said.

A number of states have been proactive, issuing explicit guidance waiving nexus — and in some cases, changes to apportionment — in response to COVID-19 employee relocation.

In New Jersey, the Division of Taxation on March 30 announced that it is waiving its rule that “treats the presence of employees working from their homes in New Jersey as sufficient nexus for out-of-state corporations” for cases of telecommuting done in connection with the pandemic. On May 6, the state also issued guidance saying it will not assert sales tax nexus based on employees working from home in the state due to COVID-19. South Carolina on May 15 said it will “not use changes solely in an employee’s temporary work location due to the remote work requirements arising from, or during, the COVID-19 relief period” from March 13 through September 30 “as a basis for establishing nexus” — including for P.L. 86-272 purposes — “or altering apportionment of income.”

Other states and jurisdictions that have issued similar guidance include Alabama, the District of Columbia, Georgia, Indiana, Maryland, Massachusetts, Minnesota, Mississippi, North Dakota, and Pennsylvania and Philadelphia.

However, many states still haven’t made their intentions clear. According to Do, COST is worried that the nexus issue could ensnare employers. She argued that states shouldn’t seek taxes from businesses in response to employees telecommuting from within their borders as a result of the crisis.

“It’s an immediate problem,” Do said. “The biggest worry is a state taking a look, auditing an out-of-state company, [and] from there saying [the company is] doing business purely on the basis of teleworking” employees.

Experts say businesses need to be aware of the issue and be proactive in ascertaining their exposure. Walczak said he hopes that states that haven’t issued waivers will follow the lead of those that have explicitly waived nexus, arguing that the move is good policy because “businesses have very little control over where their employees are based during this crisis.”

States “should not use the health crisis as a way to levy taxes otherwise not available to them,” Walczak said.

Pascal said she thinks state tax authorities would not be aggressive in pursuing nexus created by COVID-19-related telecommuting during the lockdowns.

“The only states that have come out with guidance have said, ‘Companies, don’t worry, having telecommuters in this state isn’t going to give your company nexus if they’re required to work from home,’” suggesting that many other states may take a similar approach, Pascal said.

However, even if states take a lenient approach to employee nexus during the lockdown orders, how they view telecommuting that continues after temporary rules are lifted is another issue, Pascal said.

Some sources predict that the longer telecommuting continues after lockdown orders are lifted, the less accommodating some taxing authorities would be regarding nexus.

However, if states or localities do try to press the issue of tax nexus arising from telecommuting employees, some businesses might be able to mount a challenge in light of the circumstances. “The incidental relocation of an employee, especially done without the express intention of an employer, even if it was passively allowed, might allow for a legal challenge,” under some state laws, Walczak said.

Withholding Issues

Withholding and employment tax obligations triggered by employees telecommuting in states they don’t usually work in is another issue businesses are facing. States’ rules for when

companies have to withhold taxes for employees working within their jurisdictions vary, and other factors — such as reciprocal agreements between some states and “convenience of the employer” rules — also shape companies’ withholding responsibilities. Practitioners argue that the situation is complicated for employers.

Some states have issued guidance to clarify how withholding for workers displaced by the pandemic will be handled. “A couple of states like New Jersey are saying, ‘Keep doing things the way you’ve always done them,’” Pascal said.

New Jersey, Pennsylvania, Massachusetts, Georgia, and South Carolina have advised employers to keep withholding their taxes for employees who normally work within their jurisdictions but are now temporarily out-of-state. Mississippi said that it won’t change withholding requirements for businesses based on employees’ locations during the pandemic and that it won’t impose new withholding obligations on businesses — Nebraska and Alabama have also put out similar guidance. Maryland said in early May that it won’t use employees’ temporary locations to assert “additional withholding requirements,” and Georgia said it won’t require withholding for employees temporarily working in-state. Illinois said it will forgive interest and penalties for out-of-state employers that fail to withhold for employees working in the state because of COVID-19.

Businesses’ withholding obligations for telecommuting employees are affected by the interplay of different states’ rules. For example, Massachusetts’ April 21 guidance exempts employers from withholding state income tax for a resident who normally works in another state but is now telecommuting from within Massachusetts because of COVID-19, “to the extent that the employer remains required to withhold income tax with respect to the employee in [that] other state.” South Carolina’s guidance has a similar line.

In some cases, reciprocal agreements between states will determine where employers withhold taxes on workers’ income. For example, Pennsylvania and New Jersey have a reciprocal agreement, which “eliminates wage sourcing issues” for employees shifting work locations between the two states, “as there is agreement to

not tax the wages of a resident of the other state,” according to New Jersey’s guidance. Maryland also has reciprocal agreements with most of its surrounding states.

There are “so many moving pieces on this,” Kearns said. To determine withholding obligations, employers need to look at the rules or guidance of the state where an employee is currently working, as well as the rules/guidance of the state where he or she normally works.

Kathleen Quinn of McDermott Will & Emery told *Tax Notes* there may need to be further clarification of issued guidance. In particular, the New Jersey tax division instructed employers to maintain their existing withholding arrangements for employees. But Quinn said that the way the guidance was written could be interpreted as focusing on in-state employers with employees who regularly work in New Jersey but are now telecommuting from a location outside the state.

“They don’t address the opposite” — an employee who normally works in a different state for an out-of-state employer but is now working in New Jersey, Quinn said. “I suspect that New Jersey is basically saying, ‘We’re going to kind of disregard employees working [from] home’” generally, and not require changes to withholding based on employees’ relocation during the pandemic, “but the guidance isn’t very clear.”

Telecommuting employees also create potential withholding obligations in localities with their own income tax. Kearns noted that Ohio recently passed legislation that “basically provides a safe harbor” and establishes that the days spent at home teleworking in an Ohio locality during the pandemic won’t count toward the state’s 20-day threshold for withholding local income tax. Philadelphia on May 4 issued guidance saying that nonresident employees of Philadelphia employers aren’t subject to the city’s wage tax for the time they’re required to work outside the city.

Notably, along with regular income tax withholding, businesses may have to address interstate telecommuting’s implications for taxes on deferred compensation. “You have to figure out the working days you were in the state” during the lockdown, Kearns said. “It’s just something that employers need to think about.”

While some have issued guidance, many states still haven't indicated whether they'll apply different withholding and employment tax rules to COVID-19-related telecommuting. And Pascal said that many businesses with COVID-19-related telecommuting may not have modified their withholding during the lockdowns, particularly given the complexity of tracking employees and the suddenness of the orders issued in response to the pandemic.

Employers that fail to withhold for employees can face penalties and interest, and in some cases, liability for taxes that aren't withheld. However, Pascal said, states might not aggressively enforce withholding rules, at least for the initial lockdown periods. Reciprocal agreements between some states will also prevent changes to withholding for many employers. Kearns also noted that "there's sort of a bandwidth issue" for states that will limit how many businesses they go after for noncompliance.

But the situation facing employers is still uncertain. "This is going to hit companies that aren't used to teleworking," Do said. "You're dealing with all the administrative headaches, potential penalties, interest."

Do said COST is hoping that more states will issue guidance, at least to provide employers a heads-up on how they intend to treat telecommuting during the pandemic, so employers can act quickly to comply. Although lockdowns are ending in many states, "it's never too late to make a difference in issuing guidance," she said.

Since some employers may face compliance challenges, COST is also "advocating for, I think the best way to term it is flexibility . . . so [businesses] are able to offer the best available information [for] this time period" to tax authorities, which should "reduce any types of penalties and interest issues," Do said.

Sources say that a key question is how tax authorities will treat continued telecommuting after lockdown orders and other emergency measures are lifted. Employers and employees may seek to minimize the risk of coronavirus transmission by continuing remote work, but states may take a less forgiving view regarding the withholding obligations triggered by such a decision.

New York and other states with convenience of the employer rules, which require state income tax withholding by in-state employers for nonresident employees working out of state for convenience rather than necessity, could pose a challenge. Telecommuting from out of state after lockdowns are lifted may be viewed by those states as a matter of unnecessary convenience the longer it continues.

The distinction could play a big role in determining whether employers in those states have to withhold for telecommuting workers, said Do. "I suspect that businesses are not going to immediately open up the second these orders are lifted and this type of teleworking is going to continue."

Unemployment tax obligations are another issue businesses and employees should be aware of. States look at where employees work, are based out of, directed from, or live to gauge to which state the unemployment tax should be paid. If employees telecommute for an extended period during and after the pandemic, it may be more difficult to discern where the tax should be paid, Do said. Notably, many states' unemployment funds are being drained because of pandemic-related layoffs.

Future Implications

According to experts, the lockdowns have drawn attention to states' disparate rules regarding telecommuting. Additionally, the displacement of employees during the pandemic could accelerate changes in work patterns and generate additional calls for states to adopt tax policies that are more accommodating for mobile workers or are more uniform in their approach to how telecommuting employees affect employers' nexus and withholding requirements.

"From everything I've read, people are predicting [that the pandemic] will have a big change on how people work and where they work, and teleworking may become more permissible by employers," Kearns said.

According to Walczak, it's possible "you could see some transition on how states deal with a much more mobile business environment, especially since, even when the health crisis abates, we will likely see changes in how businesses operate."

“States might see this as an opportunity to modernize their codes and be better aligned with teleworking and multistate business plans,” Walczak said. For example, some states currently allow employees to work in them for some time before requiring withholding and income tax payments, and “more should follow in their footsteps.”

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However, it’s not clear if states — which are immediately focused on addressing major revenue losses caused by the shutdowns — will move in that direction. Pascal said that regarding withholding rules, it’s possible some states might be moved to consider new reciprocal agreements in light of increased telecommuting, but others may have no motive to make such accommodations if it will cost them revenue. For example, “New York in particular has so many people that commute in from Connecticut and New Jersey,” Pascal said. “That’s a lot of tax revenue” the state would lose by relaxing its tax rules for mobile employees.

According to some observers, it could also be the case that if there’s an increase in long-term telecommuting, some states may actually have more incentive to pursue tax payments from workers by adopting convenience of the employer rules.

Experts say that issues with states’ withholding rules and nexus provisions during the pandemic and its aftermath could also spark renewed interest in previously introduced federal legislation intended to standardize states’ tax rules for remote workers.

One of those measures is the Mobile Workforce State Income Tax Simplification Act, which would exempt workers from filing tax returns in a state if they work in that state for 30 or fewer days a year. The Multi-State Worker Tax Fairness Act would have barred convenience of the employer tests from being used to tax or require withholding for telecommuting workers.

And the Business Activity Tax Simplification Act (BATSA) would standardize and limit the circumstances that would establish a company as having BAT nexus with a state, including requiring that a business have physical presence in a state — such as the presence of employees working there — for at least 15 days.

“The experience of 2020 could create renewed interest” in such federal legislation, Walczak said. For businesses, “trying to deal with the patchwork of different state tax laws” could underscore the merits of such proposals.

Kearns said the “whole situation does draw attention to the complexities of nonresident withholding.”

However, while federal legislation to reduce the withholding implications of telecommuting could receive a boost, it will face stiff resistance, including from states like New York, which has staunchly opposed any efforts to reduce its tax authority.

The big caveat for such proposals is “that New York state is opposed,” Kearns said. “And obviously, the members [of Congress] that are from New York are powerful.”

Pascal said federal legislation to address states’ withholding and convenience of the employer rules has been introduced year after year without success. And with more states now focused on protecting their ability to pursue revenue as they weather the post-pandemic recovery, opposition could be greater.

According to Darien Shanske, professor with the University of California, Davis, School of Law, states could do a better job simplifying their rules, but federal legislation isn’t necessarily the best solution. “I think that the approach of the Mobile Workforce State Income Tax Simplification Act is at least defensible, if not optimal,” he said in an email to *Tax Notes*, noting that “it gives firms a generous bright-line rule to plan around, which will be a boon for larger employers and relatively well-off taxpayers.”

Shanske also suggested that BATSA “is wholly retrograde as a policy matter.”

However, Walczak said he hopes that if there are difficulties for businesses as a result of telecommuting during and after the shutdowns, they’ll create an opportunity to promote

conformity between states on matters of nexus and withholding.

“There are enormous complexities” to states’ current rules, “particularly when they overlap in ways that can cause double taxation or create significant burdens on nonresidents,” Walczak said. “It can be appropriate” in such circumstances “for Congress to establish a framework for state tax policy.” ■