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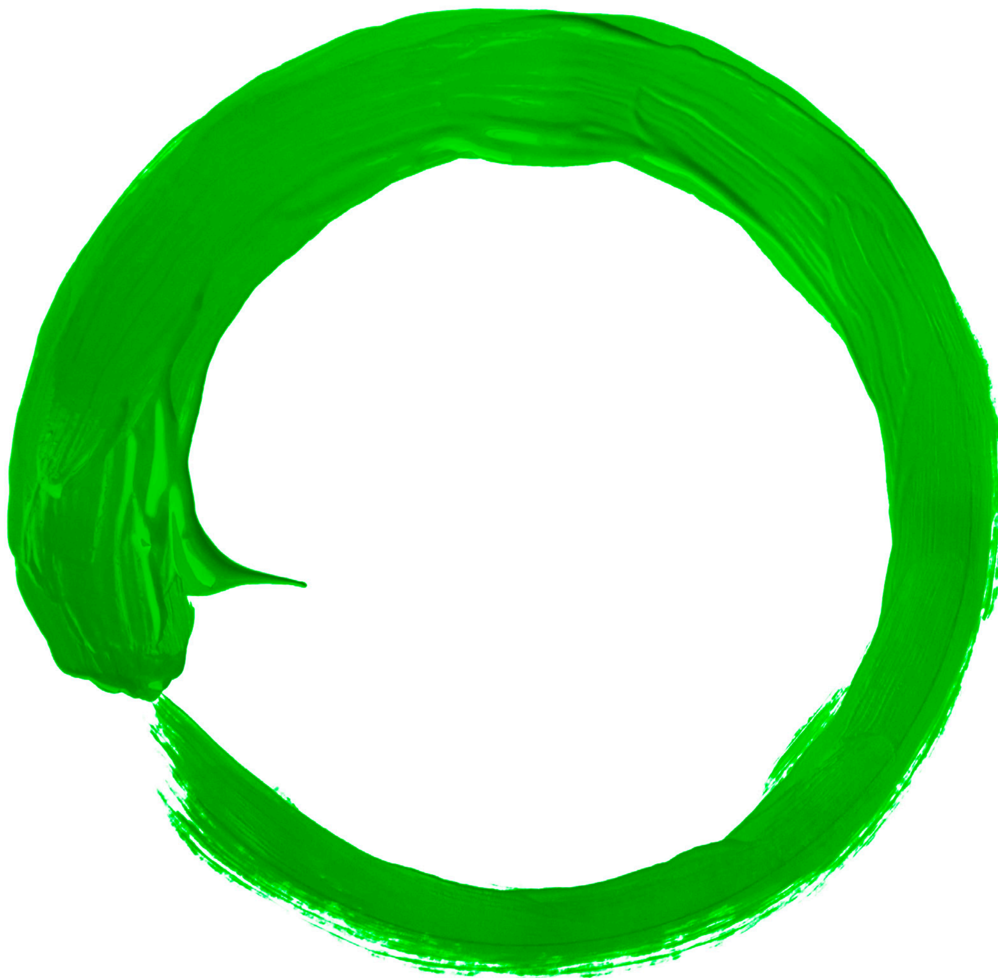

Inside Deloitte

The new normal of remote work and the impact on state filing obligations

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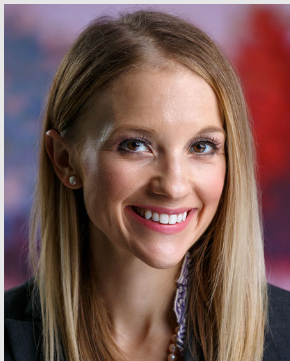

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In this installment of Inside Deloitte, the authors examine the state and local tax issues related to remote employment and technology solutions to assist companies with managing tax compliance concerns.

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Over the last two years, the landscape of remote work has evolved at an unprecedented pace. The COVID-19 pandemic has accelerated this evolution, triggering a desire by employees and employers alike to better understand the long-term prospects for working remotely. The potential impacts for both companies and the workforce are numerous. Companies may be able to decrease costs associated with real estate, while employees may experience greater productivity and reduced costs such as those associated with commuting.[1] Aside from these benefits, companies competing for scarce talent should not ignore the desire of many employees to be able to work remotely.[2] Organizations either transitioning to or already using some remote workforce should consider, among other items, the state and local tax issues related to their remote employees and technology solutions to assist with managing tax compliance concerns.

Nexus — Imposition of State and Local Taxes Based on Remote Employees

The U.S. Constitution constrains a state's ability to tax a non-domiciliary business.[3] Specifically, the commerce and due process clauses require a sufficient nexus to exist between a state and the non-domiciliary business — activities conducted by or on behalf of the business in the taxing state must exist as a prerequisite to taxation.[4] Physical presence in a state via an employee can establish taxable nexus sufficient for a state to justify taxation. Accordingly, in-state remote workers may create additional state tax filing obligations for a non-domiciliary business. Once nexus is established, a state or locality may impose a variety of taxes, including those based on net income, gross receipts, net worth, or retail sales.

While some companies have historically relied on the protection provided by federal Public Law 86-272 as grounds for not being subject to income tax even when physically present in a state,[5] P.L. 86-272 only prohibits states from imposing a *net income* tax on businesses whose sole activity in the state is the mere solicitation of sales of *tangible personal property*.[6] Accordingly, it does not provide protection for other types of state or local taxes such as taxes on gross receipts or net worth or sales and use taxes.

Moreover, when employees transition to remote work, there may be instances in which an employee performs productive work extending beyond the protection of P.L. 86-272, thereby resulting in additional tax filings in states where a company previously was not required to file. The protection provided by P.L. 86-272 is relatively narrow, and companies seeking to qualify for this protection should be aware that states have attempted to further limit its scope.[7] To the extent that P.L. 86-272 protection is claimed, the in-state activities of a company asserting its protection may be carefully reviewed by a state taxing authority.

If new state income tax filing obligations are created, the presence of remote workers may affect other state income tax items, such as the apportionment factor in states that either use a payroll factor or use a cost of performance sourcing method to compute the sales factor. Another potential impact is a company's eligibility for tax credits based on job creation. Many state credits and incentives incorporate location-specific employment requirements,

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[1] *See* "How Remote Options Will Help Firms Recruit After Pandemic," *Law 360*, Apr. 27, 2021 ("Many firms have reported that despite concerns productivity and revenue would decline as a result of the changes, they managed to be profitable and to get their tasks done. . . . Research has demonstrated that telecommuting has a very real potential to make employees' lives easier, free from the stress of daily commutes, and keep them productive when they cannot come to the office. . . . Employers that have shifted to telecommuting programs in recent years have also reported savings from increased productivity, increased retention of workers, and reduced absenteeism from employees, according to the report.").

[2] *See* Association of Legal Administrators, "Remote Working as an Effective Recruitment and Retention Tool for Law Firms Post-COVID-19," Apr. 2021 (stating younger employees increasingly say they value a work-life balance above all other considerations and are attracted to employers that offer the flexibility to work remotely).

[3] *See generally Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

[4] *Id.* at 436-37.

[5] *See Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214 (1992) (concluding P.L. 86-272 did not apply because the business activities in the state were not considered ancillary or de minimis).

[6] 15 U.S.C. sections 381-384.

[7] For instance, the Multistate Tax Commission, on August 4, 2021, adopted the fourth revision to its "Statement of Information Concerning Practices of the Multistate Tax Commission and Supporting States Under Public Law 86-272," in which it proposes a narrow interpretation of P.L. 86-272 protections for activities conducted over the internet.

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and a relocating workforce could cause a company to drop below employment requirements in a granting jurisdiction, thereby jeopardizing previously established credits and incentives based on job or head count requirements.

At the height of the pandemic, several states provided various forms of nexus relief for employees that were encouraged to work from home. However, many of these filing protections have now expired. Thus, it is essential for companies to determine the effect that remote work has on their state tax footprint, not only regarding state income tax but also non-income-based taxes, including, but not limited to, payroll and withholding taxes.

Potential Impact of Remote Workers on Payroll And Withholding Taxes

From a payroll and withholding tax perspective, the compliance challenges of employees working in multiple states are not new. Business travel and telecommuting existed before the pandemic, and many states sought to enforce payroll reporting obligations on employers in the context of nonresident employees. However, the pandemic and the transition to a new normal — as characterized by remote work and technology-enabled flexibility — have drawn attention to the difficulty of applying complex and often inconsistent payroll withholding and reporting requirements. Also, income tax withholding and unemployment obligations stemming from locations of remote workers may require new state payroll registrations for companies and could significantly change an organization's administrative costs.

The relationship between the state where an employee resides and that where the employee works falls into one of three broad categories:

- states that have entered into either a reciprocal or a reverse credit agreement;
- pairs of states where both states will assert the right to tax (and potentially withhold), but double tax is typically mitigated by a credit claimed in the resident state; and
- instances when the employment state adopts a "convenience of the employer" test and asserts the right to tax 100 percent of income related to people employed in the state, regardless of residency or where the work is performed.

Reverse Credit and Reciprocity States

In a standard multistate employment situation (that is, no reciprocity and no reverse credits), the state where the work is performed has the primary taxing right, and double tax is avoided by claiming a credit in the resident state. When a reverse credit agreement exists, the nonresident state allows a credit for the tax liability in the resident state. Effectively, the nonresident state only taxes income earned in its borders to the extent the nonresident state's tax rate exceeds the resident state's rate. Thus, when a reverse credit agreement applies, an employee's state of residence continues to have the primary taxing right, which helps avoid double taxation. However, the reverse credit agreement will not insulate the employee from a higher rate charged by a nonresident state. If the nonresident state imposes a lower tax rate than the resident state, then the reverse credit would completely offset the tax liability associated with the nonresident state.

Example: An Oregon resident who works remotely in California is only subject to tax in California on the California liability amount that exceeds the Oregon liability amount. In contrast, a California resident working temporarily in Oregon would not have any Oregon tax liability because the California tax rate on wages exceeds Oregon's tax rate.

Although reverse agreements generally mitigate double taxation on wages, these agreements might not alleviate an employer's requirement to report wages and withhold in the nonresident state, which may create a cash flow disadvantage for employees that will not be relieved until tax returns are filed.

Reciprocal agreements reduce the complexity associated with employees working in multiple states.

Example: As a result of the reciprocal agreement between Pennsylvania and New Jersey, a Pennsylvania resident working remotely in New Jersey would not be subject to income tax in New Jersey, nor would the

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employer be required to withhold New Jersey tax.[8]

It is important to note the requirement in this example that the employee adequately certifies Pennsylvania residency. An extended stay in a remote state, a change in circumstances, or an intent to change could be sufficient to cause the employee to become a resident in the remote state, in which case the reciprocal agreement would not apply, and a withholding obligation would exist in the remote state.

Nonreciprocity States

Although reciprocal agreements simplify the withholding requirements associated with multistate employment, these agreements are not the norm. Most states will assert the right to tax the income that nonresident employees earn within a state's borders. However, the threshold at which employment income becomes taxable in a state varies considerably and may be expressed in days or dollars. Similarly, the point at which an employer must withhold varies from state to state. For example, California requires that all wages earned in the state by a nonresident be subject to withholding regardless of the amount,[9] whereas Hawaii does not generally require withholding until a nonresident has worked, or is expected to work, more than 60 days in the state.[10] To further complicate the issue, the point at which a taxpayer becomes subject to tax may be different from when an employer is required to withhold. In New York employers are generally not required to withhold New York income tax from nonresidents that do not work for more than 14 days in the state.[11] In contrast, a nonresident employee working in New York could potentially be required to file a New York personal income tax return to report wages after as little as one day of work in the state.

Convenience of the Employer Doctrine

The convenience of the employer doctrine, as implemented by a small number of states, asserts the right to tax nonresidents on income earned outside the state if (i) the employee is assigned to a work location and supports a business function in the state and (ii) the nonresident's presence outside the state is based on the employee's preference rather than the convenience of the employer. Ultimately, the doctrine can generate a significant financial burden for the employee and a potentially problematic situation for the compliant employer. Some states have adopted a lenient approach to resident state credits. For instance, New Jersey residents may claim a credit for taxes paid to other states (for example, New York) even when the work is performed in New Jersey; employers are also not required to withhold New Jersey tax on this income. However, for some taxpayers, the convenience of the employer doctrine creates double taxation that simply cannot be resolved.

Example: A New York employee decides to work remotely from California. Under the convenience of the employer doctrine, the employee would remain subject to New York tax and incur California tax on the wages earned in California.

New York was the first to adopt the convenience of the employer doctrine, though several other states have followed suit (for example, Connecticut, Delaware, Nebraska, and Pennsylvania).[12] A handful of states that adopted the convenience of the employer doctrine have recently either renounced its application or allowed it to lapse.[13]

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[8] *See* NJ-WT, New Jersey Income Tax Withholding Instructions (Jan. 2021).

[9] California Employment Development Department, 2021 California Employer's Guide (Jan. 2021).

[10] Hawaii Department of Taxation, Booklet A, "Employer's Tax Guide for the Withholding, Payment, and Reporting of Hawaii State Income Tax Withheld" (2021).

[11] New York Department of Taxation and Finance, Taxpayer Guidance Division, Tech. Memo. TSB-M-12(5)I, "Withholding on Wages Paid to Certain Nonresidents Who Work 14 Days or Fewer in New York State" (July 5, 2012). Various exceptions apply to the general rule regarding employer withholding in New York, most notably in relation to deferred compensation. *See id*.

[12] New York Department of Taxation and Finance, Office of Tax Policy Analysis Technical Services Division, TSB-M-06(5)I, "New York Tax Treatment of Nonresidents and Part-Year Residents Application of the Convenience of the Employer Test to Telecommuters and Others" (May 15, 2006).

[13] Through a legal counsel opinion from the Arkansas Department of Finance and Administration, Arkansas effectively adopted the convenience of the employer doctrine but then repealed application of the doctrine during 2021. Similarly, Massachusetts adopted the doctrine to tax employees that previously worked in the state but then began to telecommute during the pandemic; however, the Massachusetts rule lapsed in September 2021.

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Navigating the New Normal

During the pandemic, telecommuting became prevalent for many people, but as we transition through the crisis, many employers and employees are not simply going back to business as usual. Although business travel is starting to recommence, employees are increasingly mixing business and leisure travel. Employers need to know not only where employees are located but why they are there because withholding rules and tax reimbursement policies may hinge on the purpose of travel. Employees have begun to embrace working remotely; however, with many states requiring day 1 reporting and withholding, remote employees may inadvertently create a compliance burden for their employers and themselves alike — a burden that may last for years to come if an employee receives long-term compensation.

Not only have employee and employer behaviors changed, but the tax compliance requirements continue to shift. Temporary COVID-19 relief that had somewhat reduced compliance difficulties may have expired, potentially creating new exposures when facts are unchanged. Also, the convenience of the employer doctrine that results in double taxation in some instances remains unresolved and may create an imbalance in state revenues, which is something that states must begin analyzing more closely as remote work in all forms increases.

Technology Considerations for Remote Work Policies

Following the peak of the pandemic, employers continue to grapple with the implications of working remotely. If an employer determines remote work is a viable option for its employees, the employer must provide clear guidance to employees by settling on a policy that can be clearly articulated and is easy for employees to follow. For companies that provide employees with the flexibility to work remotely, it is important that controls establish an arrangement that facilitates effective work and supports a company's objectives. Whether a company's policy establishes remote location restrictions, duration thresholds, or mandates the number of days working in an assigned office, technology is likely needed. Technology enables employees to submit remote work requests while allowing human resources and program managers to assess and monitor such requests in a streamlined and manageable way. Technology tools are enabling organizations to implement remote work requests and support decision-making from start to end.

Technology tools can assess remote work requests across various compliance areas, with company policy acting as a key criterion. Once an employee submits a request, the technology may first assess the request against key company identifiers. This may include analyzing an employee's job title or business unit, among other factors. An organization may choose to prioritize requirements differently based on an employee's seniority, role, or reason for requesting to work remotely. It is important that technology tools can account for these decision hierarchies and assess the risk of requests.

To meet compliance obligations, the details of the requests need to be tracked and cases managed. Some cases might need to be escalated for special consideration by appropriate subject matter specialists. Technology can enable efficient and fast decision-making. For many companies, multiple stakeholders from across the organization may be involved in the evaluation of each remote work case. By using technology tools, the review process can occur concurrently or sequentially based on how an organization prioritizes compliance areas. Either way, technology can reduce the burden on the remote work approval team by automating many aspects of the evaluation process.

For employees whose requests are approved, either automatically or after a further review, technology tools can provide case management features to monitor and initiate next steps, such as keeping track of remote work start and end date changes, location updates, and changes to employee demographics that may affect the approval of the remote work request. Case management technology is particularly important in situations in which an employee chooses to extend a trip or indicates a

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change to the initial request that may increase the risk to an employer. In a time of uncertainty and constant change, remote work technology tools provide guidance, consistency, and scalability throughout the submission, evaluation, and case management processes.

Conclusion

Employees working remotely raise myriad tax-related issues for companies to consider and address. Each state may have different rules about how nexus is imposed because of remote workers. Some states may continue to provide temporary pandemic-related relief, while others have already ended those temporary rules and are imposing tax and payroll withholding and reporting requirements under existing laws in this new normal of remote work. It is incumbent on employers to understand all the challenges associated with remote work and implement technology solutions that can aid those policies so that employers can effectively manage the compliance obligations associated with remote work. ■

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