Telecommuting: Don't Allow State Tax Issues to Disrupt the Connection

by Hollis L. Hyans and Amy F. Nogid


Hollis L. Hyans


Amy F. Nogid

Telecommuting has grown exponentially in the last few years. The number of employees working remotely at least one day per week rose 74 percent from 2005 to 2008,[1] with 20 million to 30 million doing so in 2008. Recently the U.S. Senate unanimously passed the 2010 Telework Enhancement Act to expand telecommuting opportunities for federal employees.[2] A white paper issued collaboratively by the U.S. General Services Administration and the Telework Exchange, a public-private partnership, set out some of the benefits of telecommuting, including:

- reduction of carbon emissions because of decreased vehicle use;
- increase of employee morale and decrease of stress;
- accommodation of employees with disabilities and those with family care issues;
- reduction of office space needs and operating costs; and
- continuity of operations during emergency situations (for example, terrorist attack, pandemic influenza, and natural disaster).[3]

State and local government agencies are also recognizing the need for and are implementing telecommuting programs.[4] By one estimate, if 33 million Americans were to telecommute, oil imports would decrease by between 24 percent and 48 percent, greenhouse gases would be reduced by up to 67 million metric tons per year, and as much as 7.5 trillion fewer gallons of oil would be consumed per year.[5]

Despite the burgeoning telecommuting workforce in government and private industry, and the clear imperative supporting the institution of broad-based telework programs, state and local income tax laws and withholding tax provisions remain muddled and inconsistent and, when employers and employees are not careful, risk placing telecommuters and their employers at a considerable disadvantage from a state and local tax perspective.

Nexus

No good deed goes unpunished. An employer that allows its employees to telecommute and perform work in a state in which it does not already have nexus — that is, does not have a sufficient connection with that state to allow the state to assert tax jurisdiction under the U.S. Constitution — could find itself subject to income tax and responsible for the collection of sales tax (to name just a couple of the potential tax obligations a state could assert) in the state from which the employee telecommutes.

---

[1] Undress for Success and the Telework Research Network, Telecommuting Statistics, *available at* http://undress4success.com/research/telecommuting-statistics/ (last visited June 9, 2010).

[2] S. 707, 111th Cong. (2010).

[3] U.S. General Services Administration and the Telework Exchange, "The Benefits of Telework" (September 2008), *available at* http://www.teleworkexchange.com/pdfs/The-Benefits-of-Telework.pdf (last visited June 9, 2010).

[4] Virginia established an Office of Telework Promotion and Broadband Assistance in 2006, and Georgia established Work Away program in 2003 and enacted a telework tax credit, Georgia Code Annotated section 48-7-29.11, which became effective on July 1, 2007.

[5] *Id.* at 3-4.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Recently the New Jersey Tax Court ruled that a software developer that "regularly and consistently permits" an employee to work from her home in New Jersey is doing business in the state and is subject to New Jersey's corporation business tax.[6] The court concluded that a corporation is "'doing business' at the place where its employees are expected to report for work, where they are regularly receiving and carrying out their assignments, where those employees are supervised, where they begin and end their work day, and where they deliver to their employer and customers a finished work product."[7] The court also said that because the employee used a laptop provided by the employer, the company also employed property in the state, which further supported the conclusion that the company was doing business in, and was therefore taxable in, New Jersey. The court rejected the company's challenge under the due process clause of the U.S. Constitution, holding that the company had "fair warning" that it could be subject to New Jersey law because of its employment relationship with an individual working for it in New Jersey. Also rejected by the court was the company's claim that the daily presence of the employee in the state failed to satisfy the "substantial nexus" requirement of the commerce clause.

As the New Jersey Tax Court cautioned:

> "[I]t is for the taxpayer to make its business decisions in light of tax statutes, rather than the other way around" . . . That [the company] may not have realized the State tax consequences of its business decisions regarding the employment of [the telecommuting employee] does not insulate the company from corporate tax liability.[8]

Unfortunately, once a corporate toe has been dipped in state waters, it's not just the toe that gets taxed. States have aggressively pursued tax policies intended to grab the maximum amount of tax revenue from those with the least connection to the state, thereby exporting tax burdens. Employers should therefore consider the implications of telecommuting *before* approving telecommuting requests of their employees.

Personal Tax Liability and Tax Withholding

An employee's decision to telecommute can also have significant, unintended state income tax implications for the employee. Individuals are generally subject to tax on all of their income by their state of residence, regardless of where that income is earned. Also, most states that impose a personal income tax also provide that even a single visit to the state by a nonresident is sufficient to subject that employee to tax by the nonresident state.[9] Although most states provide a credit for personal income taxes paid to another state, that credit mechanism has been found not to be required under the U.S. Constitution,[10] leaving the potential for double taxation a real and serious problem.

> ***Employers should consider the implications of telecommuting*** **before** ***approving telecommuting requests of their employees.***

A labyrinth of state rules — that may or may not be tied to the employee's personal income taxability threshold — exists regarding employers' withholding obligations. For example, in at least a couple of states, even though nonresidents are subject to income tax based on a single day's presence, employers are not required to withhold unless an employee is present for at least 14 days.[11] In many states, the withholding obligation starts the first day the employee travels to the state,[12] while in other states the employee's earnings attributable to

---

[6]*Telebright Corp. v. Director, Div. of Taxation*, No. 011066-2008, 2010 N.J. Tax LEXIS 4 (N.J.T.C. Mar. 24, 2010). (For the decision, see *Doc 2010-6907* or *2010 STT 60-14*.)

[7]*Id.* at 14.

[8]*Id.* at 21-22 (citations and quotations omitted).

[9]Some states exempt some activities, such as attendance at trade shows or seminars, from being activities that create nexus (and potential income tax liability) for an employee.

[10]*Tamagni v. Tax App. Trib.*, 695 N.E.2d 1125 (N.Y.), *cert. denied*, 525 U.S. 931 (1998).

[11]*E.g.*, Connecticut and New York.

[12]A map provided by the Council On State Taxation to the Multistate Tax Commission with its *Mobile Workforce Briefing Book* (Sept. 9, 2009) reflects the following states as requiring withholding from the first day that an employee travels to the state: Alabama, Arkansas, Colorado, Connecticut, Delaware, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, and Vermont. Those states fail to recognize that a single-day visit to a state is de minimis and should be an insufficient basis to support a nexus determination. *See, e.g.*, *Arizona Dep't of Revenue v. Care Computer Sys., Inc.*, 4 P.3d 469 (Ariz. Ct. App. 2000) (seven visits of out-of-state personnel within a seven-year period to solicit business and follow up on business opportunities was deemed sufficient to establish nexus); *Orvis Co. v. Tax App. Trib.*, 654 N.E.2d 954 (N.Y.), *cert. denied sub. nom. Vermont Info. Processing, Inc. v. Comm'r*, 516 U.S. 989 (1995). Twelve visits over a three-year period were found to be sufficient to establish substantial nexus. As the U.S. Supreme Court stated in *Wisconsin Department of Revenue v. William Wrigley*, *Jr., Co.*, 505 U.S. 214, 231 (1992) (citations omitted), "the venerable maxim *de minimis non curat lex* ('the law cares not for trifles'), is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept."

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the state must exceed a specific wage threshold, and yet other states use an alternative threshold using number of days or dollar amounts.[13] Even when a day threshold is adopted, the determination of what constitutes a day is not always clear: Does traveling through a state count? Does a portion of the day count? Implementing a tracking system for employees is essential, but even with such a system in place difficulties in administration exist. Some states have reciprocal agreements with other states that allow an employer to withhold income taxes in the employee's state of residence regardless of where the employee performs those services, which can help reduce an employer's burden.

For employees who are telecommuting and performing services in multiple states, ensuring that the employer withholds and remits taxes to the appropriate jurisdictions can also be a challenge. Generally, an employer is required to withhold and remit taxes only in the jurisdictions in which it does business, but its employees may be telecommuting from and providing services in jurisdictions in which the employer maintains that it is not doing business (despite the potential nexus issues discussed above). Some states authorize an employer to deduct and remit withholding taxes to the state of a nonresident employee if the employee provides written authorization.[14] However, if a telecommuting employee has income tax obligations to multiple jurisdictions, not all states provide an easy mechanism for a nonresident to direct the employer to limit withholding based on the portion of services rendered in state.[15]

Further complicating personal income tax and withholding are issues such as New York's "convenience of the employer" rule.[16] New York's rule provides that days spent by a New York state nonresident employed to provide services in New York, but who works at home outside the state, are to be sourced to the New York office, unless that work was performed outside the New York office for the necessity of the employer rather than the employee's convenience.[17] New York courts have consistently rejected challenges to the convenience of the employer rule.[18] The state's basis for the convenience of the employer rule is that in the absence of such a rule, in-state and out-of-state employees would not be on a level playing field; residents would not be able to exclude income attributable to the work they perform in their homes while nonresidents would be able to do so.

Recently, an administrative law judge rejected New York state's assertion of tax against a software consultant and programmer and recognized that even the convenience of the employer rule has its limits.[19] The individual was a New Jersey resident who worked exclusively in and reported all of his wages to New Jersey. His employer was an Illinois-based company with a one-room office in New York City. The individual did not, however, ever work from the New York City office, and on those facts the ALJ held that no New York tax was due. Although the proper result was reached in this case, the assertion of a liability under this factual scenario is

---

[13]The COST map lists 16 states as having thresholds other than one day of travel into the state. Nine states are listed on the COST map as having no general personal income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming).

[14]*See, e.g.*, Ariz. Rev. Stat. section 43-408; 18-125-803 Maine Code R. section 3; N.J. Admin. Code section 12:55-2.5. The voluntary collection and remittance of withholding to another jurisdiction may not "eliminate, reduce or replace" the employer's obligations to the state in which the employer is doing business. *See, e.g.*, N.J. Admin. Code section 12:55-2.5(g).

[15]*Cf.* New York IT-2104.1, which allows nonresidents to allocate withholding tax based on the estimate of the percentage of services that will be performed, *with* NJ-W4, which does not address decreased withholding for nonresidents who only perform a portion of their services in New Jersey. *See also* 20 N.Y. Comp. Code R. and Regs. section 132.18(a).

[16]Other states that have analogous provisions include Nebraska (316 Neb. Admin. Code 22-003.01C) and Pennsylvania (61 Pa. Code section 109.8).

[17]*See* "New York Treatment of Nonresidents and Part-Year Residents Application of the Convenience of Employer Test to Telecommuters and Others," TSB-M-06(5)I (N.Y.S. Dep't of Taxation and Fin., May 15, 2006). The report sets out the department's policy on application of the convenience of the employer test, and specifies the factors to be considered in determining whether an employee's home office will be considered a "bona fide employer office." The primary factor is whether the home office contains or is near specialized facilities. Secondary factors include whether the home office is a condition of employment; the employer has a bona fide business purpose for the employee's home office location; the employee performs some of the core duties of his or her employment at the home office; the employee meets or deals with clients, patients, or customers on a regular and continuous basis at the home office; the employer does not provide the employee with designated office space or other regular work accommodations at one of its regular places of business; and the employer reimburses expenses for the home office.

[18]*See, e.g.*, *Huckaby v. New York State Div. of Tax App.*, 829 N.E.2d 276 (N.Y.), *cert. denied*, 546 U.S. 976 (2005) (an individual working for a New York-based employer from his home in Tennessee had his entire income sourced to New York even though he spent only 25 percent of his time in New York); *Zelinsky v. Tax App. Trib.,* 801 N.E.2d 840 (N.Y. 2003), *cert. denied,* 541 U.S. 1009 (2004) (a New York University law professor who worked from his home in Connecticut and taught in New York City a few days a week was held not to be working from home for the convenience of the employer, and it was held that taxing him on 100 percent of his NYU salary did not violate the commerce clause). (For the decision in *Huckaby*, see *Doc 2005-6487* or *2005 STT 62-21*; for the decision in *Zelinsky*, see *Doc 2003-25309* or *2003 STT 228-10*.)

[19]*In re Kumar*, DTA No. 822747 (N.Y.S. Div. of Tax App., Admin. Law Div. May 6, 2010). (For the decision, see *Doc 2010-10791* or *2010 STT 97-20*.)

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

a potent reminder that state tax issues can arise even when an employee has only the most tenuous connections to a state.

The welter of rules, exceptions to rules, and nuances of rules can place a significant withholding compliance burden on companies. Telecommuting employees are at risk for tax assertions by the jurisdictions to which they have traveled or in which they have performed services. In the current economic environment, the quest for tax dollars (particularly from nonvoters) has increased and states' enforcement of nexus and withholding rules has likewise increased.

Employers will also have to determine the jurisdiction of employment for telecommuting employees for unemployment insurance purposes. Under the definition of employment adopted by most states, employment by a single employer of an employee performing services in multiple states is not to be fragmented, but should be allocated to the state where the employee is most likely to become unemployed and seek work. States apply the following successive tests to determine the state of coverage:

- localization of employee's services;
- employee's base of operations;
- place of employer's direction and control of employee; and
- residence.

Under those statutes, split coverage will be allowed only if none of those tests results in the services being attributed to a single state.[20]

New York's highest court applied that definition to an employee telecommuting from Florida who performed services for a New York-based corporation.[21] The court held that the telecommuter was located in Florida, where she was physically present, and that therefore Florida, not New York, was responsible for the payment of unemployment insurance benefits. However, when a telecommuter performs services in multiple jurisdictions and is not localized to a single jurisdiction, it is unclear how the uniform rule will be applied by state labor departments and courts.

Federal Intervention

In response to increased audit activity over the last few years, business groups have proposed federal legislation to prohibit states' use of the convenience of the employer rule and to provide a uniform threshold before employers would be required to withhold taxes.

In August 2004 the Telecommuter Tax Fairness Act[22] was first proposed. It would bar the convenience of the employer rule and require that an employee be physically present in the state as a precondition to imposition of tax on that worker. The legislation was most recently reintroduced in May 2009.[23]

The Mobile Workforce State Income Tax Fairness and Simplification Act was first introduced in 2006[24] and reintroduced most recently in 2009. That legislation would address the taxation of nonresident employees (excluding professional athletes, professional entertainers, and some public figures) and would set a threshold of days below which a state could not subject the nonresident to state income tax. Although the initial bills had proposed a 60-day threshold, because of state clamor a compromise was reached between employers and states, and in the most recent iteration of the bill, a 30-day threshold was proposed.[25]

The Multistate Tax Commission has proposed a mobile workforce withholding and individual income tax model statute that would decrease the threshold to 20 days. The MTC's model statute provides that a nonresident's income from work performed in the state of nonresidence would be exempt from withholding if the nonresident:

- has no income derived from the nonresident state;
- worked fewer than 20 days in that state (days in transit would be exempt from the day count); and
- resides in a state that has a reciprocal exemption or does not impose a personal income tax.

The MTC's model statute takes a broader view than most states do of the types of individuals excluded from the withholding protection: professional athletes, persons of prominence who perform services on a per-event basis, professional entertainers, construction laborers, and key employees. Qualifying employees would not have a filing requirement in the state of nonresidence and employers would not have a withholding requirement regarding qualifying employees. However, the model act does not explicitly address nexus issues. At least one state, Montana, has criticized the MTC's model statute and the "working presence test" as creating complexity in states that have an income threshold

[20]New York State Department of Labor, "Determining Jurisdiction of Employment When Services Are Performed in a Number of States" (undated), *available at* http://www.labor.state.ny.us/ui/pdfs/ia1163.pdf; N.Y. Labor Law section 511.

[21]*In re Allen*, 794 N.E.2d 18 (N.Y. 2003).

[22]H.R. 1360; S. 785, 109th Cong. (2005).

[23]H.R. 2600, 111th Cong. (2009).

[24]H.R. 6167, 109th Cong. (2006); H.R. 3359, 110th Cong. (2007); H.R. 2110, 111th Cong. (2009).

[25]H.R. 2110, 111th Cong. (2009).

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

for taxability, even claiming that nonresidents working fewer than 20 days could receive "special, favorable tax treatment" because a nonresident high-income earner would be excused from filing returns while a resident with lower income would have to file.[26]

Although states take umbrage at the potential incursion on their sovereign immunity by Congress, the patchwork of disparate rules and the considerable compliance burdens decrease the competitiveness of companies in the worldwide marketplace and warrant federal intervention under the commerce and foreign commerce clauses to ensure that interstate and foreign commerce is not unduly impeded by a myriad of state and local rules. With the explosive expansion of technology facilitating telecommuting, and the environmental, societal, and security concerns addressed by telecommuting, congressional action is sorely needed. In the meantime, employers and employees alike must consider the state tax implications of telecommuting arrangements and plan ahead to avoid unexpected assertions of nexus and withholding duties for the employer and personal income tax issues for the employee. ✰

Hollis L. Hyans and Amy F. Nogid are with Morrison & Foerster LLP in New York City. Hyans can be reached at hhyans@mofo.com and Nogid can be reached at anogid@mofo.com. *The authors would like to thank Mollie B. Gabrys for her valuable assistance with this article. Portions of this article were included in "How to Save Gas . . . and Prevent Heartburn: The Legal Issues Surrounding Telecommuting," published in Morrison & Foerster LLP's* Employment Law Commentary *(June 2010), which Hyans and Nogid coauthored with Edward Froelich, Kalinda Howard, and Janie Schulman.*

© Copyright 2010 Morrison & Foerster LLP. The views expressed in this article are those of the authors only, are intended to be general in nature, and are not attributable to Morrison & Foerster LLP or any of its clients. The information provided herein may not be applicable in all situations and should not be acted on without specific legal advice based on particular situations.

[26]Montana appears to minimize the fundamental difference between residents and nonresidents (who are taxable on all of their income regardless of where it is earned, subject to a credit if offered by the state). Clearly, greater governmental resources are expended to maintain the infrastructure and provide governmental services for individuals who are in the state 365 days a year than for those who are in the state for less than 20 days. In its comments to the MTC model act, Montana also criticized the MTC's adoption of a physical presence test, which it views as inconsistent with the economic nexus standard long supported by the MTC:

> If the Commission were to endorse a physical presence test for individual income taxes, it has the potential for undermining the credibility of the Commission with regard to its historic opposition to federal legislation imposing a physical presence test on states for the imposition of their business activity tax. The commission should be consistently supporting economic measures, instead of physical presence measures, with regard to the imposition of different forms of income taxation.

E-mail from Dan Bucks, director of revenue, state of Montana, to Shirley Sicilian, MTC hearing officer (May 10, 2010) (*available at* http://services.taxanalysts.com/taxbase/eps_pdf2010.nsf/DocNoLookup/10431/$FILE/2010-10431-1.pdf). The economic nexus test fails to give appropriate consideration to the fourth prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), which requires that the tax imposed be fairly related to the benefits provided by the state to the person the state subjects to tax and be reasonably related to that person's presence or activities in the state.

(C) Tax Analysts 2010. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.