Match Point: Tax Obligations Of the Mobile Workforce

by Charles C. Kearns, J. Page Scully, and Jonathan A. Feldman

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State personal income taxes are an important source of state tax revenue.[1] However, these taxes impose significant and potentially expensive requirements on employers throughout the United States, requiring employers to accurately and timely withhold and pay these taxes to state and local governments. Although complying with the witholding requirements in an employee's state of residence often is routine, complying with nonresident state and local withholding requirements associated with traveling employees is complicated at best and impossible at worst. Given the increase of traveling employees of companies of all sizes, there has been much discussion about the appropriateness of these complex withholding rules. It is time to reform and simplify employee withholding requirements. Further, the simplification effort should make consistent the liabilities imposed on employers *and* employees. This article examines the grounds for matching employers' withholding obligations with nonresident employees' personal income tax return filing obligations. We conclude that meaningful multistate uniformity efforts must provide that the obligations have identical thresholds because of the numerous complexities surrounding multistate withholding compliance.[2]

Background

States typically tax residents on all their worldwide income, regardless of the source of the income or where it is earned. Arkansas, for example, taxes the "entire income of every resident."[3] If an employee works outside the state of residence, that "work state" generally taxes the employee's income earned in that state based on the number of days worked in the state or some other measure.[4] Double taxation is avoided because the residence state typically provides a credit for taxes paid by the employee to the work state.[5] However, the effectiveness of the credit depends in part on the relative tax rates between the residence state and the work state. If the work state tax rate exceeds the tax rate of the residence state, the individual's total personal income tax liability will be greater than if all income had been earned in the individual's state of residence.

Herding Cats — Multiple Levels of Nonconformity

State withholding tax laws are nonuniform and inconsistent. States not only have different thresholds for determining when a company must begin withholding income tax on a traveling employee, but they also have different measuring sticks. Many states look to a dollar threshold and impose a withholding requirement on reaching that threshold. Others impose withholding on the first dollar

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[1] *See* Federation of Tax Administrators 2009 State Tax Collection by Source at http://www.taxadmin.org/fta/rate/09taxdis.html.

[2] This article does not address the proper uniform metric for nonresident withholding (for example, "working days" in the state or income derived from service performed in the state). Indeed, any uniformity effort in the multistate withholding context without a uniform withholding threshold across states is arguably pointless.

[3] Ark. Code section 26-51-201(a).

[4] *See, e.g.*, 61 Pa. Code section 109.8.

[5] *See, e.g.*, Va. Code Ann. section 58.1-332.

earned by nonresident employees.[6] And some states do not focus on dollar thresholds but solely on the number of days that the employee spends working in the state and impose a withholding requirement on reaching that minimum number of days (which, in some states, is one day).[7] Finally, some states have rules that look at a combination of dollars earned and days worked in the state.[8]

> ***Meaningful multistate uniformity efforts must provide that employers' and employees' withholding obligations have identical thresholds.***

Although many states' rules are relatively clear and set forth a bright-line withholding threshold, many other states' rules are ambiguous.[9] The New York State Department of Taxation and Finance issued audit guidelines that provide that an employer need not withhold tax from an employee's compensation if it reasonably expects that employee to spend 14 working days or less in the state.[10] For purposes of determining a working day, the department uses the "one hour equals a day" rule, whereby entering New York for any part of the day to perform work on behalf of the employer will count as a full day toward the 14-day threshold.[11] Connecticut recently adopted similar policies.[12]

The variation in the laws governing withholding of a nonresident employee's state income tax can lead to double taxation in some instances or no withholding in others. Under New York's and Connecticut's withholding rules, for example, an employer can be required to withhold both New York income tax and Connecticut income tax of an employee for the same days of work because any part of a day spent working in each state counts as a working day. Thus, if a nonresident employee spends half a day in New York and the other half of that day in Connecticut, the employer will be required to withhold New York personal income tax and Connecticut personal income tax on the employee's wages for that one day.

However, some states provide for less harsh counting rules. Those states' laws can lead to no withholding tax obligations for a day if an employee spends part of a day in one state and part of a day in another. Although those states relieve the employer of withholding, when contrasted with the double withholding that would be required by Connecticut and New York under the same facts, uniformity and consistency is necessary to avoid those unintended consequences.[13]

Different Thresholds (for Employees and Employers)

State laws or tax agency policies often differ as applied to employers' withholding requirements and employees' personal income tax liabilities. In some cases, the nonresident employee is responsible for paying income tax on the first dollar earned, but the employer's responsibility for withholding is triggered only after the employee spends a specific number of days working within the state. For example, Arizona has a de minimis rule that provides that employers need not withhold from employees who are physically present in the state for fewer than 60 days in a calendar year.[14] Thus, the income of an employee working for 59 days in Arizona will not be subject to withholding, but that same employee is nevertheless required to report and pay income tax on wages earned in the state during those 59 days.[15]

When the employer is under no obligation to withhold personal income tax, it is left to the employee to understand the state personal income tax implications of performing work functions in states

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[6] *See, e.g.*, Neb. Admin. Code section 21-001 (imposing a withholding threshold of $600 for persons engaged in business in the state or having a business location in the state or $5,000 if not).

[7] *See, e.g.*, Ariz. Rev. Stat. section 43:403(A)(5)(b).

[8] Georgia's de minimis rule requires withholding on wages paid to employees who work in the state more than 23 days in a calendar quarter, or whose wages for services performed in Georgia exceed $5,000 or 5 percent of their total annual compensation. Ga. Code Ann. sections 48-7-100(10)(k); 48-7-1(11)(A).

[9] Some states' de minimis withholding rules apply only to relieve the employer from withholding, and do not relieve an employee from an income tax filing obligation. A state may require an employee performing services in the state to file an income tax return even though her employer is not required to withhold tax from her wages paid for work done in the state.

[10] *See* New York Non-Resident Allocation Audit Guidelines (Apr. 5, 2005).

[11] *See id*.

[12] Connecticut Announcement No. 2010(3), Jan. 11, 2010.

[13] To alleviate potential double withholding, some neighboring states have entered into withholding reciprocity agreements with other states, providing that each state will not impose an income tax on residents of the other state but defer taxing authority of that individual to his or her state of residence. Although nonresident withholding is not required in this situation, employees typically need to fill out a form or certificate in the state of nonresidence. Note that reciprocity agreements may not encompass local income taxes because those local taxing jurisdictions may not be party to the agreement.

[14] Ariz. Rev. Stat. section 43:403(A)(5)(b).

[15] *See* Ariz. Rev. Stat. Ann. section 43-1091; Ariz. Admin. Code R15-2C-601.

in which no withholding is required. Absent a withholding requirement, there is generally no communication from the employer to the employee of the income tax liabilities resulting from business travel to another state. That results in significant confusion and audit risk for traveling employees.

Confusion Over Deferred Compensation

Apart from the standard withholding complications discussed above, significant complexities occur regarding deferred compensation. By the time deferred compensation becomes taxable, the employee may have changed her state of residence (which may or may not tax deferred compensation in a similar manner) or may have changed employers. Congress has limited states' ability to tax deferred compensation in some circumstances. Federal law (the Source Tax Act) prohibits a state from imposing "an income tax on any retirement income of an individual who is *not* a resident or domiciliary of such State (as determined under the laws of such state)."[16] However, that law does not prohibit states from taxing residents or domiciliaries, regardless of whether the resident earned the now-taxable deferred compensation in another state. Further, the Source Tax Act does not prohibit states from taxing income other than retirement income earned by nonresidents for service rendered in that state, such as nonqualified stock options. Accordingly, multistate withholding issues involving deferred compensation not protected by the Source Tax Act are ripe for inclusion in uniformity efforts or in an amended act.

Deferred compensation presents several complex issues when determining the proper states for which to withhold tax. For instance, an employee who earns compensation that is deferred over a five-year vesting period (and who receives a new grant of deferred compensation each year) will have to consider whether that deferred compensation is taxable by the states she worked in while earning it, or by the states she worked in once the compensation vests. The potential exists that withholding is required on the deferred compensation to states that the employee briefly worked in during the vesting period even if the employee has not worked in that state for several years.

Further, the acquisition of a company typically involves the transfer of employees who are entitled to numerous items of compensation such as severance payments, some of which may be deferred compensation. Indeed, deferred compensation arrangements are becoming commonplace among many types of employees, not just a company's most senior executives. When officers of Target in State A are relocated to State B, or retire and move to State C, the acquiring company needs to consider withholding compliance in one or more of those states. For example, Target employed Officer in State A but required, as a condition of his employment with Acquirer, to move to State B. Officer received a deferred compensation payment while resident in State B, but the entirety of that payment was compensation for service performed in State A. State B law requires the employer to withhold tax because Officer earned the payment for service rendered in the state.[17]

Under different facts, assume Officer was granted nonqualified stock options while resident in State B as an employee of the Acquirer. Officer works in State B for five years of a 10-year exercise period. Officer then moves to State C, which does not impose a personal income tax, and exercises in year 10. On an option exercise:

- the resident state generally taxes 100 percent of the spread;
- the nonresident state generally taxes a portion of the spread based on the days of service in the state in the period between grant and exercise; and
- the resident state gives a credit for nonresident state tax.

Applying those rules, State C would have no tax withholding, of course, because it does not impose a personal income tax. However, State B would tax half of the spread, so you would apply State B withholding to half of that compensation.[18]

[16]P.L. 104-95; 14 U.S.C. section 114 (as amended by P.L. 109-264) (emphasis added). The legislation prohibits a state from imposing an income tax on retirement income of an individual who is neither a resident nor a domiciliary of that state, as determined under the laws of such state at the time the income is received. "Retirement income" subject to preemption means income from any governmental retirement system plans, qualified retirement plans, and all other deferred compensation plans and nonqualified retirement plans, if that deferred compensation plan income or that nonqualified retirement plan income (1) is paid in a series of substantially equal periodic payments (not less frequently than annually) for the life or life expectancy of the recipient or the joint lives or joint life expectancy of the recipient and the recipient's beneficiary, (2) is paid in a series of substantially equal periodic payments (not less frequently than annually) for a period of not less than 10 years, or (3) is a payment after termination of the recipient's employment and is made under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of (i) the limitations imposed by one or more Internal Revenue Code sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415, or (ii) any other limitation on contributions or benefits in such code on plans to which any of such sections apply.

[17]*See generally* Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, para. 20.05 (Warren, Gorham, and Lamont, Aug. 2010) (describing states' authority to tax the income of individuals based on residency and source).

[18]*See, e.g.*, Conn. Agencies Regs. 12-711(c)-5(a)(2).

The above examples illustrate the need for uniformity not only of states' withholding thresholds but also of states' calculation of income subject to withholding. Deferred compensation compliance issues typically arise well after the employee has established residency in another state or has separated from service with the employer. In either case, the employer may be faced with a difficult human resources issue. For example, an employee receiving a deferred compensation payment (other than those protected by the Source Act) may be surprised to learn the payment is subject to withholding in a state where she worked years ago, particularly if she retired to a state with no personal income tax.[19] The matching of the withholding and personal income tax filing thresholds can go a long way to lessen the compliance burdens associated with deferred compensation.

Practical Considerations

With the patchwork of state nonresident withholding responsibilities, it is no surprise that nonresident withholding creates administrative headaches for businesses with traveling employees. Nonconformity between employer withholding and personal income tax liability compounds the interstate nonconformity among states in connection with employer withholding thresholds. The following summarizes some practical considerations when such intrastate nonconformity may increase the adverse effect of adopting companywide withholding policies.

Step One — Acknowledging the Problem

Under section 404 of the Sarbanes-Oxley Act of 2002, management is required to certify that processes and procedures are in place to comply with applicable law and regulations, including state and local nonresident income tax withholding.[20] The establishment of that requirement for public companies, along with the personal liability of some officers and directors, has significantly increased the interest and attention that businesses have placed on this issue. The tracking of working days in a state (for purposes of ensuring compliance with a state's withholding law or an employer's withholding policy) depends on the adequacy of the employer's internal processes. For example, companies often track employees' working days through time reports. However, the burden of reporting out-of-state travel is often placed on the employees, with the employer asking them to accurately report on their time reports the jurisdiction in which they are working. Because reporting and withholding of wages earned in a nonresident jurisdiction may require the filing of multiple, if not dozens, of additional state income tax returns, and because of the potential for additional or double taxation that may result from multiple filings, it is common for employees to fail to properly report all time spent outside the home state. Thus, even for companies with a sophisticated employee travel tracking system that can calculate and determine the proper withholding thresholds and "turn on" withholding when those thresholds are met, those systems are only as accurate as the data being entered into the system.

HR! HR!

Failure to withhold state income tax accurately directly affects the employees' personal income tax obligations, which may create challenging issues associated with employee relations and communications. Often, employers implementing new withholding procedures find one of the most — if not *the* most — vexing challenges is explaining those arcane withholding rules and policies to employees. Thus, it behooves many company tax departments to develop explanatory, educational materials, and offer Q&A sessions concerning an employer's withholding policy. Employees working in states that have high withholding thresholds but low personal income tax filing thresholds are typically most perplexed as to why a return must be filed and tax paid out of pocket.

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Also, proper withholding related to deferred compensation is problematic because the company is dealing with former employers — some of whom may have left on less than amicable terms. In that case, proper explanation of the withholding rules should accompany any payment subject to nonresident state withholding. In those states where a significant disparity exists between thresholds, the employer may not be under any legal obligation to withhold or notify the former employee of her filing obligation. However, some employers may find it beneficial to inform former (including retired) employees of their potential filing obligations, even if withholding is not required.

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[19]Personal income tax audits concerning deferred compensation paid to recent transplants to states without personal income taxes (for example, Florida) are common and likely to increase as states search for revenue without imposing "new" taxes on its residents.

[20]P.L. 107-204, section 404 116 Stat. 745 (2002).

Mitigating Audit Risk

As with many other tax types, state departments of revenue have increased audit activity in connection with withholding and personal income tax. To minimize audit risk for both employers and employees, employers typically adopt national withholding policies and procedures that comport with the laws of the state where their highest-paid employees travel. Although those standards likely increase overall compliance, lessen compliance costs, lessen (but not eliminate) audit risk, and minimize the adverse human relations effect of withholding by making the employees' wage withholding more predictable, such national standards are not, by definition, in full compliance with each state's specific withholding requirements.

Failure-to-Withhold and Failure-to-File Penalties

Finally, employers are liable for payment of the employee's tax required to be withheld regardless of whether they have actually withheld and remitted it, and some states impose *personal* liability on corporate officers for tax that is not withheld and remitted to the state.[21] Depending on the state, failure-to-withhold penalties could be imposed per occurrence or, like personal income tax failure-to-file penalties, could be based on a percentage of the withholding tax that should have been shown on the return. For example, Virginia's penalties for failure to withhold by an employer and failure to file a personal income tax return are 6 percent of the tax that should have been withheld per month, up to 30 percent.[22]

Simplification Efforts

Federal legislation (H.R. 2110, the Mobile Workforce State Income Tax Fairness and Simplification Act) was introduced last year with the support of various employers and trade groups.[23] If signed into law, H.R. 2110 would establish a national framework for states to require employers to withhold tax from a nonresident employee's wage or nonwage payments attributable to services performed in a state. Similarly, the states, working through the Multistate Tax Commission, are considering a model withholding statute in an attempt to encourage states to adopt uniform withholding tax laws. Although different in significant respects, those two proposals provide that nonresident wages excluded from withholding are also excluded from the nonresident's personal income tax. In other words, the proposals seek to match the employer's withholding obligation with the employee's return filing obligation.

Conclusion

Multistate uniformity efforts, including federal legislation such as H.R. 2110, should not only promote consistent employer withholding thresholds among the states, but also provide a correlative exclusion for the employee's personal income tax obligations. If it does so, the uniformity effort will achieve the worthwhile goal of increasing compliance among employers and employees. However, simply lowering the withholding threshold to match the personal income tax filing threshold would be unacceptable. A *reasonable* withholding threshold is paramount to any multistate withholding uniformity proposal. Therefore, the withholding threshold and a correlative exclusion from the applicable personal income tax (for example, as set forth in H.R. 2110 as currently drafted) is, in our view, the most reasonable solution to the tax issues facing multistate employers and employees. ✩

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[21] *See, e.g.*, KRS 141.340(2).

[22] Va. Code sections 58.1-475 and 58.1-347.

[23] *See* H.R. 2110, 111th Cong. (2009), *Doc 2009-9558* or *2009 STT 80-4*.