

# CONTINUED REMOTE WORKING MAY RESULT IN UNINTENDED STATE TAX CONSEQUENCES FOR EMPLOYERS

BY JEFF SCHAFFART AND NICHOLAS BJORNSON, KOLEY JESSEN



**Many employees are now at the one-year mark of working from home.** As society returns to “normal,” employers should evaluate the potential tax consequences of permitting or requiring employees who live in other states to work from home. States are considering whether a return to “normal work” should also mean a return to “normal” nexus and other taxation rules.

The main issues arise when an employee is a resident of one state while the employer’s physical location is in another. This has potential ramifications for income tax withholding; income, sales, and use taxes; and unemployment insurance.

## Income Tax Withholding

Forty-one states impose a personal income tax on wage income, but their rules vary. For example, some states have a 14-day rule stating that if an employee is working in the state for 14 days or less per year, no income tax withholding is due to that state. Other states use dollar thresholds. Others have entered into reciprocity agreements with each other that eliminate income tax withholding requirements. The issue is further compounded by potential local income tax withholding requirements. As a result, the income tax withholding laws of the state in which the employer has its primary place of business must be compared to those of the states and localities where the employer’s employees have their residences. The failure to do so may result in employees, and their employer, being under-withheld in one or more states, with the resulting

potential for interest and penalties accruing on the underpayment (or lack of payment).

Seven states, including Nebraska, tax people where their office is even if they do not actually work in the state. This is known as the convenience of the employer (COE) rule. The COE rule comes into effect if the employee works from a home in another state out of their own convenience instead of due to the employer’s necessity. For example, an employee who is based out of an office in Nebraska but works out of her home in Iowa is subject to Nebraska state tax on any compensation earned while working from home. Further, the Nebraska Department of Revenue has stated 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. Many other states provided employee withholding relief in response to the pandemic.

Massachusetts similarly advised employers to keep withholding taxes for employees who normally work within their jurisdictions but are now temporarily out of state. However, New Hampshire filed suit with the U.S. Supreme Court contending that Massachusetts taxing their residents is unconstitutional. Iowa filed an amicus brief in support of New Hampshire challenging the ability to tax nonresidents’ income while they’ve been working remotely. The outcome of this litigation should be monitored by employers who rely on the COE rule.



**When employees work in states other than where the office is located, the employer must decide whether to report and pay unemployment insurance in the state where the employee is located, or in the state where the employer is located. Unemployment insurance taxes are paid to only one state.**

States require an employer to register, file, and withhold state payroll taxes and, if the employer fails to do so, may collect these tax obligations from the employer and impose penalties and interest. Depending on the state, penalties may be assessed for each day of delinquency and interest accrues on the estimated amount of taxes due for the period covered by the withholding report.

### **Income/Sales and Use Tax**

In addition to state income tax withholding concerns, having an employee work remotely may create “nexus” for a state to impose other taxes, such as income and sales and use tax. Nexus permits a state to tax an out-of-state (foreign) entity when there is a sufficient connection (a “nexus”) between the foreign entity and the state. What constitutes nexus varies across states. For sales and use tax purposes, although most states have now adopted laws that impose an “economic” nexus based on the dollar amount of sales or the number of transactions in those states, nexus can still be created through the physical presence of employees. On the income tax side, federal Public Law 86-272 prevents states from imposing corporate income tax without a minimum level of physical presence, and it excludes certain marketing activities.

If an employer has established nexus because of employees working remotely, the rules for sourcing income and profit to the respective jurisdictions often depend on the physical presence of employees. This could materially change the apportionment of business profits. Businesses with offices in one state that have employees work from home in another state may be required to source sales to the various states where their remote workers perform services for their customers. However, businesses that solely provide either services or intangibles and have employees working in market-based sourcing states (market-based sourcing method assigns the receipts from sales of services to the location of a service provider’s customers or the destination where its customers receive the benefits of the service) should not face apportionment issues resulting from employees working from home. Employers should now be aware of these new concerns.

There is limited guidance from the states thus far in terms of income and sales and use tax nexus triggered by employees working from home. Iowa has stated that simply having a remote employee during the declared state of emergency won’t create nexus or cause the company to lose protection under Public Law 86-272. Other states and jurisdictions have issued similar guidance, but many states have not issued any relief associated with employees working from home and some states have stated that they will enforce their withholding and tax nexus law.

### **Unemployment Insurance**

When employees work in states other than where the office is located, the employer must decide whether to report and pay unemployment insurance in the state where the employee is located, or in the state where the employer is located. Unemployment insurance taxes are paid to only one state. All states require employers to use the same four-part test for each employee to make this determination, applied in descending order:

**Localization of Services.** An employee’s services are localized in a particular state if all or most of his/her services are performed in that state, with only incidental services performed elsewhere. Where the employee performs services outside of the state on a permanent or substantial basis, the services cannot be treated as localized to a particular state.

**Base of Operations.** If the employee’s services are not localized, the employer should conduct the “base of operations” test, which focuses on the place the employee customarily returns to in order to receive instructions or supplies.

**Place of Direction and Control.** If the employee’s services are neither localized, nor subject to a base of operations, the third test is the “place of direction and control,” which is often a corporate or regional headquarters where the employee gets instructions.

**State of Employee’s Residence.** If none of the previous three tests provide an answer, then unemployment insurance taxes are due to the employee’s state of residence.

If employers decide to continue to let employees work from home, the first three tests may more easily fail for a nonresident employee, thus requiring the reporting and payment of unemployment insurance taxes to states where employees have their place of residence.

In conclusion, employers should be aware of the different withholding requirements that their new employees working from home could trigger and follow guidance issued by state tax agencies. ◀



*For more information, contact Jeff Schaffart or Nicholas Bjornson at Koley Jessen at [jeff.schaffart@koleyjessen.com](mailto:jeff.schaffart@koleyjessen.com) or [nicholas.bjornson@koleyjessen.com](mailto:nicholas.bjornson@koleyjessen.com), respectively. Schaffart solves complex tax and legal issues by providing timely, pragmatic advice to private equity sponsors, general counsel, management teams, and business owners. Bjornson’s practice focuses on federal, state, and international taxation of corporations, partnerships, and individuals.*