Multi-State Payroll Withholding Issues and Potential Relief for Telecommuting Employees

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The "shelter in place" or "stay-at-home" orders that numerous states have issued in response to the COVID-19 pandemic have prompted some employers to require that their employees work remotely from their homes. As states roll back these orders, some employers will continue to have employees telecommute as they prepare their return-to-work strategies. Working from home or telecommuting may create a business presence in a state that establishes nexus, obligating nonresident employers to withhold state and local payroll taxes. The telecommuting employees may also create sufficient nexus to establish that a nonresident employer is doing business in that state and is subject to state taxes such as corporate income tax, franchise tax, and sales and use tax, which is beyond the scope of this article. This article will focus on the state payroll tax issues created by telecommuting employees and the response of some state legislatures to provide employer state tax withholding relief.

Nexus With States

Employees who reside in the state where their employers are located are subject to the income tax withholding rules of the state in which they work. For states to impose upon an employer the obligation to withhold state income taxes on an employee's wages and to register, file, and withhold state employment taxes, there must be sufficient physical contact or presence—nexus—with that state.

It is common for an employee to reside in one state and primarily work in a different state. Under the general rule, wages are sourced to the state where the employee provides the service. However, when determining whether state tax should be withheld from the wages of an employee temporarily working from home because of the pandemic, there are two factors to consider besides nexus: (1) whether a reciprocal tax agreement exists between the states and (2) whether the states are subject to the "convenience of the employer" rule.

If there is a reciprocal tax agreement between the home state and the work state, the employer most likely does not have an additional withholding obligation if the employee works from the home state. Reciprocal tax agreements generally require employers to withhold only taxes for the home state. Therefore, if an employee teleworks from his or her home state because of a stay-at-home order, it does not impact the employer's withholding obligation because the employer is already withholding taxes for the home state under the reciprocal tax agreement.

Some states apply the convenience of the employer rule. This rule states that wages paid to an employee are sourced to the work state unless the work performed outside of the work state is for "the necessity of the employer," as opposed to the employee's preference to work at home. It is unclear how states will apply the convenience of
the employer rule due to temporary work-from-home arrangements necessitated by
stay-at-home orders. However, once a state’s stay-at-home order expires, there will
be an issue of whether a telecommuting employee that continues working at home is
a necessity of the employer or the preference of the employee.

**Employer Liability**

The substantial increase in employees working from home due to the COVID-19
crisis creates a dilemma for employers. Does the presence of the employee working
from home, even though temporary, create a withholding obligation for the
employer in the employee’s home state? The answer requires employers to examine
the income tax withholding and employment tax laws of each state in which
employees are working from home. The employer may already have a withholding
obligation for the home state if a reciprocal tax agreement exists. If the convenience
of the employer rule is applicable, the withholding obligation would remain with the
work state even if the service is provided in the home state.

If an employer determines that it has a state withholding requirement but fails to
comply, what are the consequences? States that require an employer to register, file,
and withhold state payroll taxes may require the employer to pay the tax obligations
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. Besides the potential
compounding of interest, a separate collection fee could apply.

Each state has provisions for auditing employers and typically these audits are
determined randomly. An employer with no previous employment tax filing
obligation may still be audited if a former employee files a claim for unemployment
insurance benefits on wages an employer has not reported.

These penalties and fees may seem minimal and simply a cost of noncompliance.
However, the taxes, penalties and fees for several employees can become a significant
liability. In addition, some states impose personal liability on business owners,
partners, or officers for failure to timely collect and/or remit taxes. Employers may
need to conduct due diligence to determine if the telecommuting of their employees
creates employer withholding obligations.

**Nexus Relief**

Some state legislatures have addressed this dilemma by instituting nexus relief
provisions that provide a safe harbor or waiver of state withholding and tax liability
for remote work in different states during the pandemic. The relief is temporary and
the time period for relief varies by state. Generally, employers do not have to change
their current state income and payroll tax withholdings due to telecommuting
employees. States providing nexus relief typically waive un-der-withheld tax,
penalties, and interest. There is no uniform nexus relief among the states, so
employers should determine their withholding and reporting obligations state by
state.

Similar to the relief provided by the states, the Internal Revenue Service is providing
relief for purposes of determining federal income tax residency for certain
nonresident alien individuals temporarily present in the United States because of the
pandemic.
Ogletree Deakins will continue to monitor and report on developments regarding the COVID-19 pandemic and will post updates in the firm’s Coronavirus (COVID-19) Resource Center as additional information becomes available. Critical information for employers is also available via the firm’s webinar programs.