State and Local Tax Impact of Work-From-Home Arrangements

By Ivan H. Golden

Since the onset of COVID-19, millions of employees have shifted from working in offices to working from home. By some estimates, more than 60 percent of employed Americans were working remotely in the spring of 2020, and more than 40 percent continue to do so, with no end in sight.

These changes may have a profound impact on businesses' state tax liabilities and obligations.

In general, a business has nexus for state tax purposes (including income, sales, use, gross receipts, and franchise tax) if it has a physical presence in a state – including the presence of even one employee regularly telecommuting from the state. Moreover, many states continue to use a three-factor apportionment formula that determines the amount of income allocated to the state based, in part, on the amount of payroll in the state.

Pre-COVID 19, it was relatively easy for employers to manage their state tax obligations, in part by determining where to maintain offices and employ workers. Now, however, and for the foreseeable future, employers may have little ability to control or even know where their employees are working, with some employees choosing to work from home, from a vacation home, from a relative's home, or some combination thereof.

For example, consider a Chicago-area employer with an office in Illinois and employees who live in Illinois, Indiana, and Wisconsin. Pre-COVID 19, assuming the businesses' customers were all in Illinois and that its employees all worked in Illinois, the business should have nexus in only one state: Illinois. If the business allows employees to work remotely from Indiana, Wisconsin, or elsewhere in response to COVID-19, however, the business may have nexus in those states and may need to consider its obligation to file state tax returns and pay taxes in those states.

Fortunately, since March 2020, more than a dozen states have announced they will not impose nexus on employers, or require employers to allocate income to the state, based solely on the temporary presence of employees telecommuting from the state as a result of COVID-19.

But the state guidance is, at best, incomplete. For one thing, most states still have not issued specific guidance regarding whether COVID-19-related telecommuting will create nexus for tax purposes. For another, even in states that have issued guidance, the guidance generally is temporary and leaves many questions unanswered, including:

- ❖ What if an employer continues to allow employees to work remotely after the employer's workplace is allowed to reopen or after expiration of a state or local shelter-in-place order?

- ❖ What if an employer allows certain employees to continue to telecommute due to specific health or personal considerations related to COVID-19?

- ❖ What if an employer allows employees to telecommute indefinitely, without regard to whether there is a continuing COVID-19 public health emergency or a state or local shelter-in-place order?

These questions are hardly hypothetical. Many large and well-known employers have announced they will allow most or all employees to work from home indefinitely, and other prominent companies have told employees to expect to work remotely at least through June or even December 2021. If these work-from-home arrangements continue indefinitely, presumably states will, at some point, seek to assert nexus over businesses that have employees within their borders.

In addition to nexus considerations, work-from-home arrangements can affect employers' withholding obligations and employees' individual income tax liabilities.

In general, employees' salaries or wages are sourced to the state in which they perform work. Thus, an employee who works in one state but lives in another will be taxed in the state in which he or she works (the employee may also be taxed in his or her home state but typically is allowed a credit for taxes paid to other states).

For telecommuters, this means that state income tax must be withheld and paid to the state in which they work, regardless of the location of the employer. For example, if an employee of an Ohio company begins telecommuting from Illinois, the employer normally would be required to withhold and pay Illinois income tax with respect to the employee once the employee has worked in Illinois for more than 30 working days.

Only a handful of states have published guidance addressing this situation, and those that have had reached different conclusions. The Illinois Department of Revenue, for example, has said that out-of-state employers must withhold and pay Illinois income tax if they employ an Illinois resident who is working in Illinois for more than 30 working days as a result of COVID-19 – in effect, no different from the usual rule. Alabama and Georgia, on the other hand, have said they will not require out-of-state employers to withhold or pay income tax on wages paid to state residents who are temporarily working from home as a direct result of COVID-19. As with the guidance on business tax nexus, however, the guidance on state withholding is incomplete and leaves many questions unanswered.

Until more guidance is forthcoming, there are a handful of steps businesses can take to prevent unpleasant surprises. First, employers can survey their employees to determine from which state or states they are working. Second, employers can research the nexus and withholding rules in the states in which their employees are working to determine whether they have nexus or must begin withholding. These rules can get very nuanced, and nexus determines may turn on the specific services an employee is performing in a particular state. Finally, employers should consider whether to continue work-from-home arrangements indefinitely or only for the duration of the COVID-19 pandemic or state shelter-in-place declarations. On this last point, in particular, employers' work-from-home policies obviously involve numerous considerations that go well beyond taxes. But the importance of taxes, and the importance of avoiding unwanted tax liabilities, should not be overlooked.

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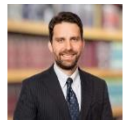

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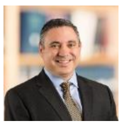

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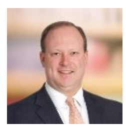

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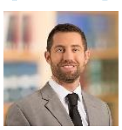

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