
Potential Taxation Without Representation: The Implications of State Taxation on Teleworking

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Beginning in March 2020, millions of Americans were forced to work from home as a result of the COVID-19 pandemic. While the absence of a commute and the option of wearing sweatpants rather than slacks during meetings were initially welcome changes to the workday, it did not seem likely that we would still be “Zooming” to work from our kitchen tables in 2021. With the pandemic still surging, many Americans have not returned to the office and will have to reckon with possible tax implications stemming from their forced exile.

Physically commuting from home in one state to work in another, such as from New Jersey to Philadelphia or New York City, is not new. Likewise, the tax implications for employees who commute are not surprising. Generally, the employee is taxed in both her home state (residence-based tax) and the state where she works through what is often referred to as a commuter tax (source-based tax), with the home state giving a credit or other accommodation to mitigate the duplicate tax cost.

Telecommuting, however, is not commuting. Employees who telecommute work from their home states. Thus, it would be reasonable for those employees to expect to only be taxed in their home state because they’re not physically crossing state lines, right? Not so fast! If Pennsylvania, New York or Delaware are involved, both employees and employers might find surprising tax results from telecommuting, even when they are simply complying with mandatory work-from-home orders. For employees of employers in these states this means that dutifully working from home across state lines in accordance with the law, they may still be subject to tax in a state they have not set foot in for nearly a year as if they were physically commuting. In turn, this may create an unintended connection between the employer and the state where the employee lives, thereby subjecting the employer to taxation there. This conundrum also underscores the internecine struggle between the states over tax dollars derived from wages earned while telecommuting.

Employees: While most employees in the country are not currently impacted by this kind of law, a problem arises for employees of employers located in Pennsylvania, Delaware and New York because they have enacted the “convenience of the employer” rules. If an employee works remotely because her employer requires it, perhaps because that is where a customer is located, the employer’s state would not tax the employee on the income earned from that work. However, if the employee works outside of the employer’s state for any other reason, the employer’s state can tax that employee’s income regardless of where it was actually earned. The convenience of the employer rule in the current environment begs this question: is a mandatory work-from-home order a requirement or a convenience? This is a question that has yet to be answered. Some states, such as New Jersey, have offered credits for its residents who are adversely impacted by this rule for the length of the pandemic.

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Employers: It is uncontested that states and municipalities can impose income taxes on businesses that have a physical location in the state or have employees who work in the state. These connections create tax nexus. The question that comes up when an employer has employees working from home in another state is whether telecommuting across state borders alone creates tax nexus to a state to which they were not otherwise connected. If nexus is created for the employer with the employee's home state, the employer is subject to that state's taxes. However, the universal nature of the COVID-19 pandemic has motivated some states to address this issue, at least in the short-term. New Jersey's Division of Taxation has stated that nexus for corporate tax and sales and use tax purposes will not be imposed on out-of-state employers during the pandemic through telecommuting employees. Likewise, Pennsylvania's Department of Revenue indicated it will not impose Corporate Net Income Tax nexus or Sales and Use Tax nexus on non-Pennsylvania businesses based solely on employees working from home in the state. The state of New York, on the other hand, has declined to issue guidance on this topic, meaning that non-New York employers of New York residents may find themselves unexpectedly exposed to New York State (and potentially City) tax.

WHAT'S COMING:

States without the convenience of the employer rule might become envious as out-of-state employees continue working from home even after the conclusion of the pandemic and the tax dollars associated with their wages remain home with them. Perhaps a harbinger of things to come, one state, Massachusetts, reacted to this tax conundrum created by the pandemic by enacting a temporary "convenience of the employer" policy. This new rule states that employees who work for Massachusetts-based employers and are working remotely outside the state because of a work-from-home order in a neighboring state are still required to pay income tax in Massachusetts. This arrangement is slated to remain in place until ninety days after the governor of Massachusetts ends the state of the emergency created by the pandemic.

Although this measure is temporary, Massachusetts has experienced backlash from other states and numerous tax organizations. In October 2020, New Hampshire petitioned the United States Supreme Court for relief, requesting that it strike down this law as an unconstitutional tax on its citizens who telecommute. The lawsuit also raises questions as to whether such convenience of the employer rules violate the Dormant Commerce Clause, which bars states from unduly burdening interstate commerce, even in the absence of federal legislation regulating the activity. This lawsuit has attracted a lot of attention in the tax community, with over a dozen amicus briefs filed in the matter, including those from Connecticut, Hawaii, Iowa, and New Jersey, as well as public policy groups such as the National Taxpayer Union, the Tax Foundation, the Cato Institute, and Americans for Tax Reform. The states joining New Hampshire did so because many of their citizens are directly impacted by "convenience of the employer" rules subjecting them to taxation in a state to which they have no physical connection and thereby draining tax revenue from the residence state. The Court has not determined whether it will hear the case, but the controversy is generating interest as other states might follow suit.

With many employees likely to continue teleworking even after COVID-19 vaccinations permit safe return to the office, it is critical to fully appreciate the impact these decisions may have on where tax is owed by telecommuters and their employers.

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