Employment Tax Briefing

Addressing the concerns of payroll tax departments

December 20, 2012

Mobile Workforce State Income Tax Simplification Act of 2012

What is the Issue?

States derive revenue by taxing residents on all income from whatever source derived and nonresidents on earned income derived from sources within state boundaries. These rules are enforced both from a personal income tax and from employer withholding perspective. Generally, if an employee works and lives in one state these rules correspond. However, if an employee is a resident of one state and works in a different state then these rules can differ. For example, in New York an employer is not required to withhold New York income tax from a nonresident employee's wages unless that employee is present in New York for more than 14 days. However, the personal income tax laws state that a nonresident's wage is taxable in New York from the first time services are performed within the state. That is, a nonresident employee's responsibility to pay and file taxes to New York is not relieved just because his employer is not required to withhold. This is an example of how the personal income tax and employer withholding rules can differ. Furthermore, withholding thresholds in general differ from state to state. Some states impose a day or dollar threshold for employer withholding requirements while the majority of states require withholding immediately upon services being performed in the state. These differences require an employer to understand where employees are performing services in order to adhere to those states' withholding requirements. In addition, the differences require an employee to be aware of how much and where his employer is withholding taxes to determine if such withholding is sufficient to meet his personal income tax payment obligations. Needless to say, this is a difficult process that has long been recognized by employees and employers alike and thus, states and state coalition groups have heard the arguments for a more simplified process for years.

In response to such complaints, states claim they are working toward national uniformity in this area. However, history cannot point to one successful example that shows a unified effort and thus, federal legislators have taken it upon themselves to propose a national standard in the form of the "Mobile Workforce State Income Tax Simplification Act of 2012." Congress has been working on this issue for many years.

In detail

What is the Mobile Workforce Income Tax Simplification Act of 2012?

The "Mobile Workforce State Income Tax Simplification Act of 2012," (H.R. 1864) seeks to establish a 30-day, uniform threshold for nonresident withholding. Its aim is to simplify an employer's obligation to withhold income tax from wages for services performed in multiple work states.

The Act, introduced by Reps. Howard Coble (R-N.C.) and Hank Johnson (D-Ga.), would prohibit states from imposing income taxes on nonresident workers, unless they work more than 30 days a year in the taxing jurisdiction. The 30-day threshold applies to "employees" other than professional athletes, professional entertainers, and public figures, who generally perform services on an event-by-event basis and, as a result, are subject to different rules.

Studies show that for a majority of states, the legislation would have little to no revenue impact. If passed, the legislation would become effective on January 1 of the second calendar year immediately following enactment.

Why is it necessary?

Nonresident withholding is a complex issue for employers. The difficulty lies not only in how to track and allocate employee time, but also in interpreting the states' differing withholding thresholds. With no uniform threshold, employers are left to analyze this issue on a case-by-case basis. Some states require nonresident withholding immediately upon an employee's performing services in a state, while others require withholding after a certain number of days or after surpassing a wage threshold. The fact that varying rules make compliance difficult, however, does not relieve an employer from its responsibility to withhold and remit personal income taxes in states in which the company *derives business income* or *transacts business*. Failure to do so creates personal income tax withholding and payment exposure for the employer and employee, respectively.

For example, if in the course of a pay period, an employee spends 30% of his time working for his employer in California and the remaining 70% in Pennsylvania (his regular work state), his wages should be allocated between California and Pennsylvania, with applicable amounts reported and withheld in each jurisdiction.

Historically, employers have not allocated wages based upon the state in which services are performed. Instead, they have withheld personal income taxes only in the state in which an employee lives or regularly works. However, two major developments in the last decade have caused employers be become better informed about and strive to comply with multistate withholding requirements. The first event pertains to Sarbanes Oxley legislation, which requires executives to affirm that the company is in substantial compliance with tax obligations. The second was the effectuation of New York's nonresident withholding audit initiative (which has generated significant state revenues since its inception in 2005) and the recent adoption by other states of similar initiatives. These two events changed the nonresident withholding landscape by assigning corporate accountability and providing state enforcement.

What is the Bill's status?

On Tuesday, May 15, 2012, the Act passed the US House of Representatives on a voice vote during consideration of noncontroversial bills on the House suspension calendar. This was consistent with the House Judiciary Committee's voice vote the previous November when the bill had been reported favorably.

Senator Sherrod Brown, a Democrat from Ohio, introduced the "Mobile Workforce State Income Tax Simplification Act of 2012," S. 3485, on Aug. 2, 2012. Thus, it is now eligible for consideration and passage by the US Senate. However, getting any tax bills through the Senate in 2012 will be a challenge. One reason is that senators are faced with significant federal issues such as mandatory budget cuts that have to be resolved this year. Another is that while the House process allows for non-controversial bills to pass by voice vote, a single Senator can hold up bills in the Senate. Notwithstanding, tax reform is considered a high priority in 2013, so timing for Senate action on the Mobile Workforce issue remains an open question.

What are other implications of the Act?

While the goal of the Act is to simplify personal income and withholding tax compliance for multistate workers and their employers, there is a concern that the Act may not address certain issues, such as the "convenience of the employer doctrine", used by a small number of states to determine where wages are earned, and state allocation rules pertaining to deferred compensation, restricted stock, restricted stock units and stock options. These are some of the most daunting issues facing individuals and employers today in the nonresident withholding arena.

Convenience of the Employer Doctrine

Under the convenience of the employer doctrine, as applied in New York State, if a nonresident works for a New York employer and divides his time between the employer's office in New York and the employee's home office outside New York, the nonresident must allocate the days spent at his home office to New York, unless he can prove that time spent outside the state was for the necessity or "convenience" of his employer. If he cannot, 100% of his salary will be deemed New York income and taxed accordingly. It appears that this rule will circumvent the intent of the Act by expanding on the idea of what it means to be "present" in a nonresident state and adding the requirement that presence (or lack of presence) is only substantiated if it is for the "convenience of the employer."

In other words, if the above employee spent 30 days in his New York office and the remaining days in his home office, under the Act his presence would not trigger a withholding requirement for his employer for New York tax but under the convenience of the employer test, the days spent outside of New York, working at home, will be considered New York days whereby he would be personally responsible for paying New York income taxes on 100% of his salary through estimated tax payments to meet his personal income tax obligations.

Of course, nonresidents can avoid New York taxation under the "convenience of employer test" if it can be proven that the home office qualifies as a "bona fide employer office." To determine this New York has provided series of factors and divided them into three groups: (1) primary factor, (2) secondary factors, and (3) "other" factors. A taxpayer's home office will constitute a bona fide employer office if it meets either the primary factor, *or* at least four out of six secondary factors *and* three out of ten "other" factors. Unfortunately, most telecommuting policies do not consider or speak to these listed factors.

Deferred Compensation, restricted stock, restricted stock units and stock options

Compensation earned in one year and paid in a later year (deferred compensation) creates trailing liabilities for both the employer and employee when an employee performs services in a state(s) that is not his resident state during the earning period. As previously mentioned, many states tax nonresidents on "income earned from sources within state boundaries" regardless of where the employee is residing or working when the income is paid. Thus, many states expect employers to withhold and employees to pay taxes on deferred compensation at the time the deferred compensation is paid to the employee, based upon where the employee worked when the deferred compensation was earned. How much of the income should be sourced to a work state is generally determined based upon an allocation ratio of “days worked in the state” to “days worked everywhere” during the earning/compensable period. For example, often times the earning/compensable period for deferred compensation and deferred bonus plans is deemed the time frame between when the benefit is granted to the employee and when the employee vests for FICA tax purposes. Likewise for restricted stock and restricted stock units. For stock options, the earning/compensable period is most commonly defined as either the time from grant-to-vest or from grant-to-exercise. These allocation rules vary per state, and like nonresident withholding on current wages, are difficult to track.

The Act does not contemplate how the 30-day threshold would apply to deferred compensation, restricted stock, restricted stock units and stock options. That is, could “days worked in the state” representing the numerator in the allocation ratio be considered zero if the 30-day threshold was not met in a given year? Or is triggering the 30-day threshold during the earning period enough to consider all days in the respective years an employee works in a nonresident state. These are the kinds of issues that will have to be considered if the "Mobile Workforce State Income Tax Simplification Act of 2012" is passed.

The takeaway

PwC’s Employment Tax practice has proven strategies to assist companies in interpreting nonresident withholding rules, quantifying risk, and establishing nonresident withholding policies. While each plan is tailored to a particular employer and its needs, a sample action plan may include many of the steps outlined below:

- Review employee data to determine states at issue
- Determine withholding needs based on travel patterns and state exposure
- Identify target employee population by functional responsibilities, compensation level, and/or travel patterns
- Develop a nonresident withholding policy including documentation and employee communications
- Develop tracking mechanism and establish policies for maintenance and monitoring
- Evaluate whether voluntary disclosures are warranted to address prior year(s) exposure

By working with PwC, companies may successfully achieve compliance with the multi-state withholding requirements. Our seasoned practitioners have experience across multiple industries and jurisdictions and include former heads of Economic Development Offices and high-level employees at Departments of Revenue—allowing us to provide deep insight in assessing your potential state and local tax liability.

Let's talk

If you have questions about the Mobile Workforce State Income Tax Simplification Act of 2012, please contact one of the following individuals:

Tom Geppel
Partner
(646) 471-3078
tom.geppel@us.pwc.com

Walter Paul
Principal
(213) 356-6560
walter.paul@us.pwc.com

Jared Curless
Principal
(713) 356-6845
jared.t.curless@us.pwc.com