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THE IMPACT OF THE PANDEMIC ON STATE AND LOCAL TAX CONSIDERATIONS FOR A REMOTE WORKFORCE

The COVID-19 pandemic has completely changed what we once thought was normal. With social distancing becoming a way of life, millions of Americans are now working remotely. And for many of them, there is no certainty as to when or if they will return to their workplaces. As the pandemic drags on, many businesses have allowed their employees to continue working remotely. While there are many benefits of a remote workforce, businesses should take a step back and ask the following questions:

- Does the business have employees who reside and work remotely in other states, and if so, what are the state payroll tax implications?
- Do the remote employees create income tax nexus in other states?
- How do the remote employees affect the business' state apportionment?

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PAYROLL TAX WITHHOLDING

Generally, if an employee both resides and works in a state outside the state in which the employer is domiciled, the employer is required to withhold only the employee's resident state taxes (in addition to Federal tax withholding).

On the other hand, the rules become a little more complicated when the employee resides in one state but works in another state. Depending on the states, the employer may be able to withhold only the employee's resident state taxes, which allows the employee to only need to file a resident state tax return. However, this is only allowed when the state in which the employee resides and the state in which the employee works have a reciprocal agreement. If there is no reciprocal agreement, then the employer generally needs to withhold the employee's state taxes for not only the employee's resident state but also the state in which the employee works (nonresident state). In this case, the employee needs to file tax returns with both the resident state and the nonresident state, but the employee should be able to effectively avoid double taxation by claiming a tax credit on the resident state tax return for the taxes paid to the nonresident state.

INCOME TAX NEXUS IMPLICATIONS

In addition to payroll tax implications, businesses should consider whether remote employees create income tax nexus in additional states. Many states have issued guidance on the income tax nexus rules for a business that has employees who work in states outside the state in which the business is domiciled. Fortunately, the guidance has been favorable as some states are temporarily excluding the remote workforce from income tax nexus implications for at least the duration of the pandemic. Businesses are realizing that the remote workforce is a viable option and will have to revisit this issue once the temporary exclusions have been lifted.

Another issue to consider is how a remote workforce affects businesses that have been protected under Public Law 86-272. Public Law 86-272 states that "no state shall have the power to impose a net income tax on the income derived from interstate commerce for

solicitation of tangible personal property." This law protects a business from being taxed by states in which the business simply delivers sales of tangible personal property. Since a remote employee's physical presence in a state could create income tax nexus in the state, the remote employee may cause a business to lose its Public Law 86-272 protection in the state.

STATE APPORTIONMENT

Now that many states have switched or have plans to switch to a single-sales factor apportionment formula that disregards payroll altogether, the remote workforce should not have a significant impact on state apportionment for most businesses. There are still some traditional three-factor formula states, but some of those states have provided guidance to exclude the compensation of remote employees from the payroll factor.

Also, a majority of states have now adopted the market-based sourcing method for sales of services. Such rules require businesses to source sales of services to the state in which the benefit of the service is received (where the customer is located). A remote workforce only affects states that still follow the cost-of-performance sourcing method since this method sources sales of services to the state in which the income-producing (employee) activity is incurred.

We understand that the pandemic has impacted businesses across state lines and many have opted to transition to a full or partial remote workforce. Do you have questions about State and Local Tax as it applies to a remote workforce? Our team of experts can assist you or your business navigate payroll tax withholding, income tax nexus, and state apportionment. Contact us today.

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Matthew Weber is a Senior Tax Manager at KROST. He has been with the firm's tax practice since July 2015 and has worked in public accounting since 2010. Before joining the firm, Matthew was a Tax Manager at PricewaterhouseCoopers in Los Angeles. Matthew's areas of expertise include federal and multi-state tax compliance and consulting for individuals, corporations, and partnerships.
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