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Increased Telecommuting Raises State Tax

As federal, state and local governments have imposed quarantines, business closures and travel bans to address the COVID-19 outbreak, the number of employees working remotely and telecommuting has risen dramatically. Businesses now might find themselves confronted by a number of state tax issues that they might never have considered.

Nexus

A business is subject to a state's tax laws when it has sufficient nexus with that state. Sufficient nexus exists when a business's connection to a state is so significant that it would allow the state to assert its tax jurisdiction, as permitted under the U.S. Constitution. Physical presence and economic presence, with some exceptions, are sufficient for most state taxes. Therefore, businesses certainly expect to have nexus in states where they have offices or other facilities and in states where they have assigned employees to actively conduct business. However, what happens when a business now has employees telecommuting from a state with which it previously did not have nexus? Unfortunately, if the answer is that if the business has nexus for one tax, that state may pursue others.

In addition to triggering the following tax issues, the employee's telecommuting also could trigger a requirement for qualification to transact business as a foreign entity in another state. Similar to the tax issues, failure to properly comply could result in penalties and interest.

Business Income Tax

The imposition of a state's income tax on a business is often tied to the extent to which a business takes advantage of or otherwise exploits a state's marketplace. How a state addresses this issue varies from state to state. While many statutory provisions addressing this issue include transaction volume and dollar amounts, many also include carrying on a trade or business. Assuming the business does not meet the requisite transaction volume, does having an employee telecommuting in that state constitute carrying on a trade or business by the entity?

The answer is not always clear, and given the extraordinary circumstances caused by the COVID-19 pandemic, it may be less so. However, one cautionary example that should cause concern is found in New Jersey. In *Telebright Corp., Inc. v. Director, Division of Taxation*, 25 N.J. 333 (2010), the New Jersey Tax Court ruled that because a business regularly and consistently permitted its employee to telecommute from New Jersey, the business itself was doing business in the state and therefore was subject to the corporation business tax. The court noted that the business expected the employee to be working from his home, provided assignments and supervision to the employee at that location, and supplied the computer that the employee used. Whether governmental and business measures taken in response to COVID-19 would change such a ruling remains to be seen.

Withholding and Employment Taxes

Employer withholding obligations vary from state to state. In a number of states, including Connecticut and New York, an employee might be subject to income tax for working in a state for as little as a single day, but the employer is not obligated to withhold tax until the employee is present in that state for a specified number of days. In other states, the withholding obligation starts the first day the employee is in that state. And in still other states, the obligation begins when a specified amount of wages is paid.

Income-sourcing rules are another consideration when a telecommuting employee works in a state different from his or her assigned work location. While most states source income based on where the employee performs his or her work, some states, including New York and New Jersey, employ a "convenience of the employer" rule. The convenience of the employer rule sources an employee's income to the state where his or her assigned office or work facility is located, unless the employee works outside that state out of necessity to the employer rather than the convenience of the employee.

When telecommuting results in an employee working in multiple states, businesses need to determine the jurisdiction of employment for unemployment insurance purposes. Most states do not fragment the treatment of the employment, and they allocate it to the state where the employee is most likely to become unemployed and seek work. Fragmenting is allowed only after the normal tests used to determine a single location fail to reach a result.

Employers need to be cognizant of workers' compensation laws in the states where they have employees working, although the laws are not an employment tax per se. Workers' compensation laws in most states provide that an employee has a right to be compensated by his or her employer for expenses incurred due to a work-related injury or illness. While workers' compensation laws are clearly applicable when an employee works in an employer's facility, a growing number of states are extending them to telecommuting employees who are injured in their performance of the duties required by their employer. Employers with employees telecommuting due to COVID-19 need to be aware of any obligations they have under the relevant state's workers' compensation laws, because failing to do so can result in fines, penalties and, in some states, criminal prosecution.

Telecommuting resulting from COVID-19 could open up an employer to another state's withholding and employment tax jurisdiction as well as additional requirements for compliance. What days or portions of days are counted for determining a withholding obligation? Where should employee wages be sourced, and for which state should the employer withhold? Which state's unemployment insurance program applies to the employee?

Recent Developments

To date, only a limited number of states have issued guidance regarding how they will treat instances where employees are required to telecommute due to COVID-19. However helpful, these do not address all of the issues that might arise.

New Jersey, in a release dated March 31, 2020, stated that under New Jersey sourcing rules, income is sourced based on where the service or employment is performed based on a day's method of allocation. However, during the temporary period of the COVID-19 pandemic, wage income will continue to be sourced as determined by the employer in accordance with the employer's jurisdiction.

Mississippi, in a release dated March 26, 2020, stated that the period of national emergency brought on by COVID-19, current withholding requirements for businesses will not be changed based on the employee's temporary telework location, and no new withholding requirements will be imposed on an employer. In addition, Mississippi will not use any changes in the employees temporary work locations due to COVID-19 to impose nexus or alter apportionment of income for any business while temporary telework requirements are in place.

Businesses and employees alike will need to confirm whether the states in which they now find themselves with telecommuters will follow suit.

Looking Forward

In states where telecommuting resulting from COVID-19 has not been addressed, employers could find themselves exposed to another state's withholding and employment tax jurisdiction, as well as additional requirements for compliance. What days or portions of days are counted for determining a withholding obligation? Where should employee wages be sourced and for which state should the employer withhold? Which state's unemployment insurance program applies to the employee?

As COVID-19 causes an increase in the number of employees telecommuting, nexus, withholding and employment taxes are just a few of the issues businesses will face. For more information regarding this and other tax-related concerns, please contact the attorneys at Day Pitney.

For more Day Pitney alerts and articles related to the impact of COVID-19, as well as information from other reliable sources, please visit our COVID-19 Resource Center.

COVID-19 DISCLAIMER: As you are aware, as a result of the COVID-19 pandemic, things are changing quickly and the effect, enforceability and interpretation of laws may be affected by future events. The material set forth in this document is not an unequivocal statement of law, but instead represents our best interpretation of where things stand as of the date of first publication. We have not attempted to address the potential impacts of all local, state and federal orders that may have been issued in response to the COVID-19 pandemic.

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