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technology
may-rathon

Domestic Employee Mobility

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Topics Covered

I. Income Tax Exemptions for "Traveling Expenses"
II. Limited Exclusion of "Commuting Expenses"
III. Limited Exclusion of "Moving Expenses"
IV. Per Diem Rules
V. Special Treatment of Certain Local Lodging
VI. State Taxation of Workers in More than One State
VII. Statutory Exemption (since 1996) for Certain Retirement Income of Former State Residents
VIII. Hopes for Similar Future Federal Limits on State Taxation of Nonresidents
IX. U.S. Taxation of Nonresident Alien Income

Overview: Why do Employers Care

- “Secondary Liability” imposed on employers for non-withheld federal and state payroll taxes.
- Information reporting penalties (at federal and state levels) for incorrect federal (Forms W-2 and 1099) or incorrect (or never filed) state-level equivalent forms.
- Upset employees (who also may be subjected to federal or state audits).
- Requests from traveling employees for reimbursements (with gross-ups) of state income taxes triggered by traveling.

I. Income Tax Exemptions for Qualifying "Traveling Expenses"

- In order to be able to deduct meal and lodging traveling expenses, a taxpayer must both:
  1. have a "tax home"; and
  2. be away from the tax home overnight (or could not reasonably be able to make the trip back to home without sleep or rest).
- Many employers use a 50-mile rule for determining when a worker is "away from home," although there is no statutory rule (apart from Code §162(h)(4), applicable to state legislators' travel).

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- Generally, a taxpayer's "home" for purposes of federal tax purposes (a "tax home") is the city or location of his or her principal place of business and not where his or her personal residence is located.
- A residence may be a principal place of business only if the taxpayer in fact works primarily at home, under facts supporting a "home office deduction."
  - In deciding whether a residence is the principal place of business for purposes of the home office deduction, it must be compared to all of the other places where business is transacted. A deduction is allowed only when the residence is the most important or significant place of business.

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Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- If the taxpayer has more than one regular place of business, the taxpayer's "tax home" is the geographic location of the principal place of business.
- Determining which location is the principal place of business is a question of fact. Factors include:
  - Total time ordinarily spent by the taxpayer at each of his business posts;
  - The degree of business activity at each such post; and
  - Whether the financial return in respect of each post is significant or insignificant.

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- An employee without a principal place of business may treat as his "tax home" a permanent place of *residence* at which he incurs substantial continuing living expenses.
- This test (permitting the permanent residence to be the tax home) is hard to meet, because a "regular place of business" is generally defined (in informal IRS guidance) as a place where the taxpayer performs services for more than a year, and works there more than 35 full or partial days per year. *See* CCAs 200026025 (May 31, 2000), 200026025 (April 30, 2000), 20010156 (June 4, 2001) and 20040063 (Oct. 20, 2003).

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Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- If a taxpayer has no principal place of business, three objective factors are used to determine whether the taxpayer's claimed "permanent residence" is his regular place of abode in a real and substantial sense:
  - whether the taxpayer has lodged in the claimed abode while performing work in the vicinity immediately prior to the current job and the taxpayer continues to maintain bona fide work contacts (job seeking, leave of absence, on-going business, etc.) in that area;
  - whether the taxpayer's living expenses at the claimed abode are duplicated because work requires the taxpayer to be away from the abode; and
  - whether the taxpayer (a) has a family member or members (marital or lineal only) currently residing at the claimed abode, or (b) continues to currently and frequently lodge in the claimed abode.

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- These factors governing identification of a "permanent residence" were originally set forth in Rev. Rul. 73-529, 1973-2 C.B. 37, and have been continually relied on by the IRS and the courts.
- These factors were also outlined in Rev. Rul. 83-82, 1983-1 C.B. 45 (which, in addition to the general tests for an "itinerant" worker, provided that travel with an anticipated stay of less than a year is presumed temporary, while travel that is expected to last (or actually lasts) 1 to 2 years is rebuttably presumed to be indefinite; while travel with an anticipated or actual stay of 2 years or more is deemed to be indefinite, regardless of the facts).

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- Rev. Rul. 83-82 was revoked by Rev. Rul. 93-86 (although the reason for the revocation was never clear, since Rev. Rul. 83-82 dealt directly with trips *away* from a particular location, while Rev. Rul. 93-86 provided rules for when travel *to* a particular location was deemed to be nondeductible, under Code § 162(a)(2)).

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- If a taxpayer has neither a principal place of business nor a permanent place of residence, that person simply has no "tax home" from which to be away.
- Such taxpayers' "homes" are wherever they happen to be and they are considered to be itinerants.
- They thus can never deduct their meal and lodging expenses while "away from home" because they are effectively *never* "away from home."

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- If a taxpayer works (or expects to work) for more than one year at a "traveling-away-from-tax-home" location, the meal/lodging expenses incurred in that travel location are nondeductible, per a statutory change to Code § 162(a), effective since 1993.
- The governing rules are outlined in Rev. Rul. 93-86, 1993-2 C.B. 71.

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Income Tax Exemptions for Qualifying “Traveling Expenses,” cont.

- Congress’s reason for adopting the statutory one-year rule, with respect to employment away from home in a single location, was that at the one-year point the employee could “reasonably have been expected to move his residence” to the location of the job site. *See Tucker v. Commissioner*, 55 T.C. 783, 786 (1971); see also *Hummel v. Commissioner*, T.C. Memo. 1977-135.

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- Code § 162(a)(2), as amended in 1993, applies to any period of employment *in a single location* if such period exceeds one year. (*See* H. Conf. Rep. No. 102-1018, 102d Cong., 2d Sess. 429, 430 (1992)).
- Thus, employees who are employed away from home in more than one location are apparently not subject to the one-year rule of Code § 162(a). (*See* PLR9536012 (June 7, 1995)). (Presumably the travel to at least two of the multiple travel locations would have to last for a significant period of time – e.g., 35 days.)

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Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- This informal special exception from the one-year rule for persons working away from home in many locations presumably applies, however, only when an employee works for significant periods of time in various travel locations, and not to very short "breaks in service," including short trips back home (as discussed below).

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- Trips back to a taxpayer's residence from a temporary assignment on days off do not qualify for continuing reimbursement of per diems or of "meals while traveling," since the traveler is back in a hometown.
- However, the travel expenses (including air transportation) for the trip home may be deductible, up to the amount it would have cost for the employee to stay at the temporary place of work. (*See* Rev. Rul. 54-497, 1954-2 C. B. 75.)
- A short trip home will not be considered a "break in service."

Income Tax Exemptions for Qualifying "Traveling Expenses," cont.

- The IRS has never issued official guidance on whether a traveler might have a "break in service" at the travel location, by traveling either back to a tax home, or to a different location, and thereby possibly "restart" the one-year clock.
- Even the unofficial guidance is inconsistent, and deals only with employment periods that are extended without breaks, not with periods of temporary employment separated by the break.

Income Tax Exemptions for Qualifying “Traveling Expenses,” cont.

- Even the IRS has conceded that formal guidance on “breaks in service” was needed – a dozen years ago!
  - *See* I.L.M. 200020055 (March 24, 2000) (a one month break was not adequate, where the employment term, initially 6 months, was extended for 8 more months).
  - *See* I.L.M. 200025052 (April 26, 2000) and 200027047 (May 10, 2000) (short break of 2 or 3 weeks is inconsequential, but one year will work).
  - *See* I.L.M. 200026025 (May 31, 2000) (break of 3 weeks or less not significant, but 7 months is significant).
  - No formal guidance was ever issued.

II. Limited Exclusion for "Commuting Expenses"

- "Commuting" between home and a "regular place of business" is never business use, even when work is performed during the trip. (*See* H. Rept. No. 98-861 at 1025, 1984 Blue Book at 566-67; *Commissioner v. Flowers*, 326 U.S. 465 (1946); *Fillerup v. Commissioner*, T.C. Memo 1988-103; IRS Pub. 463 (all noting that even if work is performed during the trip, a commute is still personal).)

Limited Exclusion for “Commuting Expenses,” cont.

- Note: The only exception, possibly allowing a deduction (or exclusion) is if commuting is necessitated due to a professional diagnosed medical condition, in which case the medical expense rules may apply.

Limited Exclusion for "Commuting Expenses," cont.

- The fact that the employee's residence and his "regular place" of business are a significant distance apart does not change this deduction denial (or income inclusion) for commuting expenses, because Federal tax law presumes that an individual's decision to reside a significant distance from his "regular place" of business is for personal purposes.
- Starting in 1990, the IRS issued a series of revenue rulings changing the longstanding definition of "commuting" (which had referenced the "first trip of the day/last trip of the night" as a "commute").

Limited Exclusion for "Commuting Expenses," cont.

- Per Rev. Rul. 99-7, 1991-1 C.B. 361, if a taxpayer has a "regular work location" away from his/her residence, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another "temporary work location" in the same trade or business, regardless of distance between the residence and the temporary work location.
- Thus, for taxpayers with "regular work locations" transportation expenses to a temporary location, (e.g., for a TEI speech) are deductible.

Limited Exclusion for "Commuting Expenses," cont.

- If the taxpayer has a qualifying home office, his residence can be his principal place of business, and therefore the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the work location is regular or temporary.
- However, if the taxpayer does not have a home office, daily transportation expenses between his residence and another regular place of business are <u>not</u> deductible.

Limited Exclusion for "Commuting Expenses," cont.

- Transportation expenses <u>between</u> business locations (whether the locations are "regular" or "temporary" are always deductible.
- Rev. Rul. 99-7 was the third in a series of IRS rulings that significantly changed the rules on deducting commuting trips. *See also* Rev. Rul. 90-23, 1990-1 C.B. 28, as modified by Rev. Rul. 94-47, 1994-2 C.B. 18.

Limited Exclusion for "Commuting Expenses," cont.

- Starting in 1990, these rulings redefining "commuting" changed the prior rule (contained in Rev. Rul. 55-109, 1955-1 C.B. 261, which had allowed deductions for trips beyond the general area of a taxpayer's tax home, and also generally allowed deductions for trips exceeding the mileage of the taxpayer's normal commute).
- The later rulings correcting Rev. Rul. 90-23, and then also correcting Rev. Rul. 94-47, were designed in order to narrow the circumstances in which a commute could be deductible.

Limited Exclusion for "Commuting Expenses," cont.

- *See Burleson v. Commissioner,* T.C. Memo. 1994-364 (in which the Tax Court prevented the IRS from applying the narrowed position in Rev. Rul. 94-47 retroactively to a particular taxpayer).

III. Limited Exclusion for “Moving Expenses”

- In 1993, effective in 1994, Congress both limited the types of moving expenses eligible for deduction, and created an exclusion for employer-provided moving expenses.
- The IRS has never issued new regulations reflecting these statutory changes.
- Code § 132(g) now provides that a “qualified moving expense reimbursement” provided by an employer will be excludable from an employee’s income if certain conditions are satisfied.

Limited Exclusion for "Moving Expenses," cont.

- Since 1994, deductible moving expenses are limited to the reasonable costs of:
  1. moving household goods and personal effects from the former residence to the new residence;
  2. traveling (including lodging during the period of travel) from the former residence to the new residence (Code § 217(b)(1)).

Limited Exclusion for "Moving Expenses," cont.

- Moving expenses deductions (and exclusions) are no longer allowed for
  - meals,
  - real estate expenses,
  - pre-move house-hunting expenses, or
  - temporary living expenses.
- In addition, the mileage limit to qualify for the moving expense deduction (and exclusion) was raised from 35 to 50 miles.

Home Sale Expenses

- In November 2005, the IRS finally released its long-awaited guidance on expenses associated with assisting relocating employees. Rev. Rul. 2005-74, 2005-51 I.R.B. 1153, addresses the use of relocation arrangements in three fact patterns and bases its analysis on whether the benefits and burdens of ownership shift from the employee to the employer.
- Employers providing relocation services to their employees should be careful to establish arrangements that are consistent with the fact patterns in Situations 1 and 2 of Rev. Rul. 2005-74, if they seek to avoid having to treat home sale expenses and losses as additional wages.

IV. Nontaxable Per Diem Plans

Two Types:

1. Full Per Diem Payments—cover meals, incidental and lodging expenses;
2. M&IE Per Diems—cover meals and incidental expenses.

Nontaxable Per Diem Plans

Important Elements to Ensure Nontaxability of Per Diems:

- Must maintain a permanent tax residence at a location that is a “non-commutable distance” away from the work location;
- Individual is not expected to work (and has not worked) at the same travel location for more than 12 months;
- Must not exceed the full per diem rates allowed by the IRS for accountable plans;
- No ability to elect to receive cash wages in lieu of per diems;
- Per diems must be paid under an accountable plan.

“Accountable Plan Reimbursements”

Four accountable plan requirements:

1. Paid in connection with the performance of services;
2. Substantiation of business connection within reasonable period of time;
3. Expense advances must be reasonably calculated not to exceed the amount of anticipated expenditures; and
4. Any allowance in excess of <u>substantiated</u> expenses must be returned.

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Determining Travel Status

Design a tax home questionnaire to determine:

1. Whether the worker has a tax home;
2. The location of the tax home;
3. Necessity for overnight travel away from the tax home; and
4. Whether the worker is expected to work continuously in one location for more than 12 months.

Substantiation Requirements

- Complicated (and burdensome) substantiation rules apply.
- Substantiation rules can be automatically satisfied through a properly administered per diem plan.
- “Deemed substantiation” rules for per diem plans.

Substantiation Requirements, cont.

An arrangement is a nonaccountable plan if an employee is not required (or fails) to substantiate expenses or return excess amounts.

The results:

- ***All*** advances and reimbursements are treated as paid under the "nonaccountable plan";
- Must be reported as W-2 wages; and
- Harsh penalties apply if the per diem plan evidences a "pattern of abuse."

Proper Calculation of Per Diem Amounts

- Full Per diem Plans—Pay lodging, meals, and incidental expenses but cannot exceed the regularly published federal per diem rates for meals, lodging and incidental expenses.
- M&IE Per Diems—Must not exceed the federal per diem rate for M&IE traveling expenses.
- Lodging Only Per Diems—Revenue Procedures do <u>not</u> apply where an employer reimburses employees <u>only</u> for lodging.
- Note: The "High-Low" rate safe harbor, in place since 1989, was considered for elimination from the IRS's rules in 2011, but in response to taxpayer's requests, has been continued.

Do’s and Don’ts For Per Diem Plans

Do’s

- *Do understand the accountable plan rules.*
- *Do ensure that per diems are advanced only for travel days, when the worker is in actual “travel status.”*
- *Do understand the cash option and wage recharacterization limitations.*
- *Do have a reasonable expectation that travel expenses were or will be incurred.*

Do’s and Don’ts For Per Diem Plans, cont.

Don’ts

- *Don’t pay tax-free reimbursements for any expenses that are already covered under a per diem arrangement.*
- *Don’t offer cash options.*
- *Don’t allow pay per diem allowances regardless of whether or not the worker travels away from home on the employer’s business.*
- *Don’t pay for vacations and/or extended periods of sick leave.*
- *Don’t pay for non-travel days.*

Can Wages Be Restructured?

- Wages can be restructured into two components:
  1. taxable wages
  2. nontaxable per diems
- Per diem plan should already be in place.
- Per diems should be based on the federal per diem rates.
- Workers should be reasonably expected to incur travel expenses.
- Advanced amounts must be repaid to the employer for days not travelled.

Facts That Support Recharacterized Amounts as Non-Wages

- Care must be taken if any per diem plan pays travelers less than the local prevailing wage rate for nontravelers.
- The per diems should <u>not</u> be based on an hourly rate.
- If labor laws permit, overtime payments should <u>not</u> take into account the per diem allowance.
- Do not reduce wage rates previously paid to the same worker by an amount equal to the per diem payment when persons switch assignments from a non-per diem plan to a per diem plan.
- Per diem payment should be based on travel days, not working days.
- Potential claw-back charges may apply for employees who work less than an established minimum weekly threshold.

What is a Reasonable Recharacterization?

- IRS attorneys state that a written agreement reducing wages by an amount equal to the applicable per diem rate violates the accountable plan rules.
- IRS is unlikely to raise a successful challenge to a properly structured arrangement simply because the travelers earn a wage rate less than that paid to non-travelers.

IRS's Changing Position

- PLR 9325023 (March 24, 1993) - nonaccountable plan ruling where an annual election prior to each calendar year reduced the amount of gross compensation in exchange for tax-free expense reimbursements. (IRS concluded that Code § 62(c) was not satisfied).

IRS's Changing Position, cont.

- 1998 unpublished Field Service Advice (FSA)- IRS conceded that restructuring of a compensation arrangement on a going-forward basis was <u>not</u> a per se violation of the rules.
- "If, however, a recharacterization violates the business connection requirement, an employer that has not historically maintained a reimbursement arrangement would be precluded from adopting an accountable plan."
- Taxpayer was permitted to restructure its compensation package to provide for tax-free expense reimbursements, provided the restructured plan satisfied the business connection requirement.

IRS's Changing Position, cont.

PLR 9822044 - involved a mandatory salary reduction arrangement paired with an expense reimbursement arrangement:

1. The plan reimbursed authorized deductible business expenses up to the lesser of actual expenses or a flat dollar reimbursement cap.

2. Unused salary reduction amounts were forfeited.

The IRS ruled that the plan was an accountable plan.

IRS's Changing Position, cont.

PLR 199916011 (January 11, 1999) - Accountable plan exists where employees were offered *an election* to reduce commissions in exchange for tax-free expense reimbursements.

- The IRS later announced (in PLR 200035012 (September 1, 1999) that it was reconsidering the ruling and the conclusions may no longer be relied upon.
- These announced reconsideration of an elective expense reimbursement plan (offered in exchange for a salary reduction agreement) was not extended to non-elective plans (like the one approved in PLR 9822044).

IRS's Changing Position, cont.

- Distinguishing Between Valid and Abusive Arrangements.
- The salary reduction arrangement was not discretionary on the part of either the employer or the employee.
- Participation was mandatory for all employees.
- The amount of salary reduction and the reimbursement cap were determined independently of each other.

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Errors Causing Taxable Per Diems

Ways for a Nontaxable Per Diem to Become Taxable:

1. Per Diem Plan becomes nonaccountable plan;
2. Per Diems not paid in accord with annual IRS Revenue Procedures;
3. Worker fails to maintain a permanent tax residence;
4. Worker loses permanent tax residence due to travel for too long for the residence to remain a “tax home”;
5. Worker is expected to work (or actually works) away from tax home in one location for more than 12 months, without any adequate “break in service”;
6. Worker is provided a choice between receiving cash wages or per diem;
7. Wages are improperly recharacterized as nontaxable per diems.

V. Special Exception for Temporary Lodging: Notice 2007-47

- In May 2007, the IRS announced an odd and limited moratorium on challenges to certain types of temporary lodging expenses, which are <u>not</u> clearly excludable as a working condition fringe or as “moving expenses,” and under the longstanding Reg. § 1.262-1(b)(5), logically would be viewed as “personal expenses.”
- This exclusion was clarified, but narrowed, in proposed regulations under Code sections 162 and 262 published April 25, 2012 (77 Fed. Reg. 24657-24660).

Special Exception for Temporary Lodging: Notice 2007-47, cont.

- In Notice 2007-47, 2007-1 C.B. 1393, the IRS announced that it plans to amend Reg. § 1.262-1(b)(5), and, pending that amendment, it will NOT challenge the deduction (or exclusion) of any expenses for lodging of an employee not incurred while the employee is traveling away from home that an employer provides to the employee, or requires the employee to obtain, under the following conditions:
  1. The lodging is on a temporary basis;
  2. The lodging is necessary for the employee to participate in or be available for a bona fide business meeting or function of the employer; and
  3. The expenses are otherwise deductible by the employee, or would be deductible if paid by the employee, under Code § 162(a).

Special Exception for Temporary Lodging: Notice 2007-47, cont.

- The rumored reason for this ruling (providing a moratorium on audits of certain non-travel-away-from-home expenses) was that the IRS Commissioner was concerned about taxation of lodging at some large conference, attended by employees who had homes in the area but who nevertheless stayed at the conference hotel.

Special Exception for Temporary Lodging: Notice 2007-47, cont.

- The Proposed Regulations and their preamble (released 4/25/2012) better explain the operation of this proposed deduction (or exclusion) of certain lodging expenses related to some "bona fide business meeting, conference, training activity, or business function," but narrow its application in three ways:
  1. The "temporary period" in which the lodging is provided cannot be more than 5 calendar days, and cannot recur more frequently than once per calendar quarter;
  2. If the lodger is an employee, the employer must REQUIRE the employee to remain at the activity or function overnight; and
  3. The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

Special Exception for Temporary Lodging: Notice 2007-47, cont.

- These proposed regulations are not effective until after the date they are published as final regulations (although taxpayers "may" rely on them at their election.
- Otherwise, until the publication of final regulations, Notice 2007-47 would control.

Special Exception for Temporary Lodging: Notice 2007-47, cont.

- The Notice and the proposed regs do not apply to “per diems” (because “lodging-only” per diems are not “accountable plans.”)

- The Notice does not appear to apply (and the proposed regulations would certainly not apply) to Senators and Congresspersons who regularly sleep in their offices, instead of paying for lodging in DC - but IRS audits of Congress are unlikely…

VI. State Taxation of Workers in Multiple States (& ER Withholding Obligations)

- Companies with peripatetic workforces – employees and contractors working in, and moving among, many different states, either in a single year, or over the course of the vesting period for bonuses, stock options, restricted stock, or other equity compensation, have special problems, due to myriad state laws governing the taxation of residents and nonresidents.

State Taxation of Workers in Multiple States: Impediments/Opposition

- Form W-2 includes spaces in Boxes 15-20 at the bottom of the Form, for reporting income to TWO DIFFERENT STATES (separated by broken line).
- The IRS Instructions to Form W-2 say “If you need to report information for more than two states or localities, prepare a second Form W-2.”
- Payroll systems may not accommodate (or capture) multiple work locations.
- But employees almost invariably complain if employers report wages in more than one state.

State Taxation of Workers in Multiple States: Employer Withholding

- The "employer nexus" to trigger withholding, for most states is:
  - Employer office in state, or some other nexus to trigger state income tax; and
  - Payments of any wages subject to income tax in the state (or subject to contribution under the state's unemployment compensation laws).

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State Taxation of Workers in Multiple States: Employer Withholding, cont.

- Some states provide thresholds before withholding is triggered, based on days worked, dollars earned, or some combination of the two. (*See* map.)
- Examples:
  - NY – reasonable expectation that employee will work under 15 days in NY;
  - GA -23 days a quarter, or GA-allocated wages exceeding 5% of total compensation;
  - CT – 14 working days a year;
  - ND – 20 working days a year.

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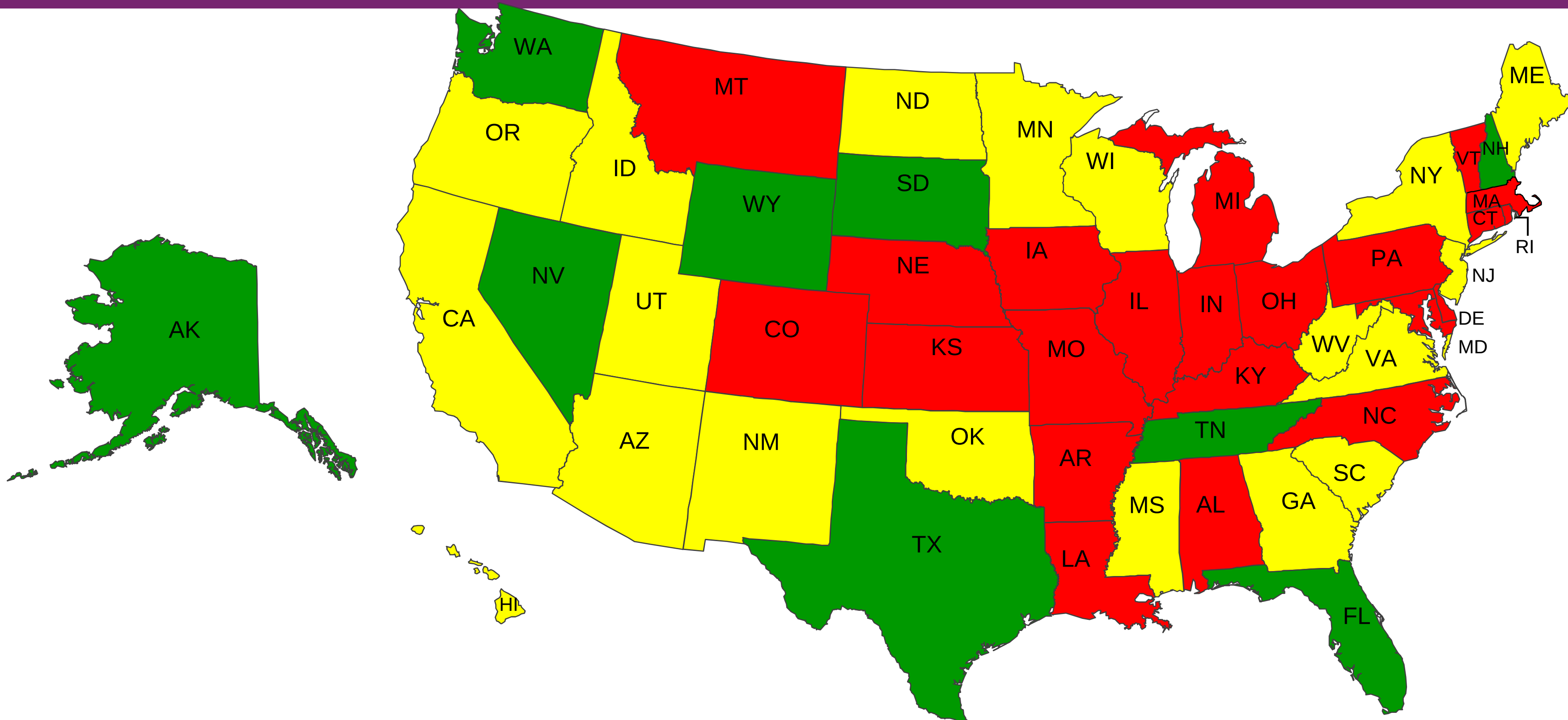
Overview of Thresholds



- Nonresident employees subject to tax withholding on *first day* of travel
- Nonresident employees subject to tax withholding after reaching threshold
- No general personal income tax (or, in the case of Washington, DC, no tax on nonresidents)

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State Taxation of Workers in Multiple States: Risks of Employer Audits

- As with any payroll audits, it is simpler for state/local tax officials to audit employers, holding them liable for non-withheld income taxes where allocated wages exceed the state's personal exemption, because that is more efficient than finding and auditing individual employees.
- If employers have neither reported nor withheld on the income, it is extremely unlikely that any nonresident of a state would have voluntarily paid income taxes (thereby enabling the employer to abate its liability for nonwithheld income taxes).

State Taxation of Workers in Multiple States: Risks of Employer Audits, cont.

- However, it is nearly impossible for employers to keep track of day-counting income allocation rules (or with 183+ days residency tests).
- Some states have poorly explained rules on income allocations.
- Many states are not aggressive in auditing nonresidents, or in conducting payroll audits.
- Some states (e.g., N.Y.) have been operating “amnesty programs” or “Voluntary Disclosure Agreements” to encourage employers to voluntarily confess their withholding/reporting errors.

State Taxation of Workers in Multiple States: Some N.Y. Horror Stories

- <u>Part-Day Counting</u>: Any portion of a day in N.Y. can trigger allocation of income to NY. *See Matter of Holt*, DTA No. 821018 (2007) ("petitioner [a Florida resident] finds it incredible that an individual's presence in New York for a portion of a day constitutes a day for New York tax purposes").
- <u>No Minimum Number of Days</u>:Many states have some minimum number of days of work in the state before state income-allocation rules apply. N.Y. does not.

State Taxation of Workers in Multiple States: Some N.Y. Horror Stories, cont.

- Meeting Burden of Proof to Show Non-Resident Status: In In the matter of *Julian H. and Josephine Robertson*, NY DTA 822004 (2009 *and* 2010), N.Y. auditors had maintained that a couple had been in N.Y. for 183 days and that the taxpayers' records showing time outside NY were inadequate for 4 days, and thus that the taxpayers, as N.Y. residents for more than 183 days, would owe additional N.Y. City taxes totaling $26,702,341 for 2000.
- After an extensive trial, in a 100+ page opinion, the judge believed the taxpayers' testimony; after an exception was filed, the case was argued again, and another opinion was issued, and the taxpayers won again.

State Taxation of Workers in Multiple States: Some N.Y. Horror Stories, cont.

- "Convenience of Employer" Rule: N.Y. counts even services performed by any N.Y. nonresident at the taxpayer's out-of-state home which could have been undertaken at the employer's office in New York, unless the services were performed out of state for the employer's necessity, not the employee's convenience. (20 NYCRR section 132.18(a). *See, e.g.*, *Matter of Phillips v. New York State Department of Taxation and Finance,* 267 AD2d 927, 700 NYS2d 566, *lv denied,* 94 NY2d 763, 708 NYS2d 52*, Matter of Page v. State Tax Commission*, 46 AD2d 341, 362 NYS2d 599; *Matter of Simms v. Procaccino*, 47 AD2d 149, 365 NYS2d 73), *Matter of Zelinsky v. Tax Appeals Tribunal of State of New York,* 1 NY3d 85, 769 NYS2d 464, *cert denied* 541 US 1009, 158 L Ed 2d 619), *In the Matter of the Petition of Manohar and Asha Kakar*, DTA No. 820440 (Feb. 16, 2006), and *Matter of Huckaby v. New York State Division of Tax Appeals,* 4 NY3d 427, 796 NYS2d 312, *cert denied* 546 US 976, 126 S Ct 546, 163 L Ed 2d 459).

State Taxation of Workers in Multiple States: Some N.Y. Horror Stories, cont.

- *See* Edward A. Zelinsky, "New York's 'Convenience of the Employer' Rule Is Unconstitutional," State Tax Notes Doc. 2008-9044 ("New York's 'convenience of the employer' doctrine has not fared well in the court of professional opinion").
- These harsh results are one of the drivers behind efforts to enact Federal blockers on states' abilities to tax nonresidents. (*See* discussion below).

State Taxation of Employers Due to Telecommuting Employees

- *Telebright* – New Jersey Tax Court finds company subject to income tax based solely on presence of one telecommuting computer programmer.
- Company did not care where she worked
  - Employee was originally based outside NJ, but asked to continue employment after moving there.
- No solicitation/marketing activities in NJ.
- Employee's "daily presence in this State for the purpose of carrying out her responsibilities as an employee …is sufficient to satisfy the substantial nexus requirement of the Commerce Clause."

State Taxation of Workers in Multiple States: Stock Option/SAR Allocation Methods

- The state rules governing the taxation of stock options (or SARs) and the income allocation withholding rules for option income received by nonresidents vary greatly depending on the state (and some states have never adopted any option-sourcing rules):
  - Grant-to-Vest Method: Taxes option exercise income based on the percentage of time in the state between the date of grant and the date the options vest;
  - Grant-to-Exercise Method: Taxes option exercise income based on the percentage of time between the date of grant and the date the options are exercised;
  - Year-of-Exercise Method: Option spread from exercise is taxable only if services were performed during the year of exercise and not over a multiyear period;
  - Degree of Appreciation Method. This method allocates the income based on the amount of appreciation of the underlying option that occurred while the taxpayer was a resident of the state.
- The variance between the states, and from year to year within certain states, clearly suggests there is no set rule and the most appropriate method is to allocate the income based on a reasonable facts and circumstances analysis.

VII. Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents

- 4. U.S.C.§ 114, since 1996, has prohibited states from imposing an income tax on “qualified retirement plan income” and certain other types of non-qualified deferred compensation benefits paid to any individual who had earned the income while working in one state (either as a resident, domiciliary or part-time worker), but who had retired and moved out of the source state before the income was paid.

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Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- These rules were lobbied into the “interstate commerce” section of the Federal Code in 1996 by “RESIST” (Retirees Eliminating State Income Source Taxation), the American Payroll Association, and other affected mobile workforce employees.
- The rule were later extended to certain retired partners (as described in Code § 7701(a)(2)) who have “retired” under their partnership agreement.

Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- There will never be federal regulations, because no federal agency would undertake such a project.
- There are some states that have issued regulatory guidance, and some that issued private rulings on the rules' application.

Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- The definition of "retirement income" that cannot be taxed when earned by nonresidents generally includes the following items:
  - Qualified retirement plans;
  - Excess benefit plans or wrap-around plans; and
  - Certain other forms of nonqualified deferred compensation described in Code § 3121(v)(2) paid out in equal periodic installments over at least a 10 year period (*e.g.*, 11 annual installments) or for the recipient's life or life expectancy.

Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- The excepted payments from “Qualified Retirement Plans” include:
  - § 401(k) plans;
  - § 408(k) simplified employee pensions;
  - § 403(a) annuity plans;
  - § 403(b) annuity contracts;
  - § 7701(a)(37) individual retirement accounts,
  - § 457(a) eligible deferred compensation plans;
  - § 414(d) governmental plans;
  - military retired or retainer pay plans; and
  - § 501(c)(18) employee contribution trusts.

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Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- "Excess benefit plans or wrap-around plans" are defined as:
  - Plans solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.
- The description of these plans in the legislative history references a statute before it was amended in conference, which confuses interpretation of this provision.

Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- The final exception encompasses other forms of nonqualified deferred compensation described in Code § 3121(v)(2) paid out in equal periodic installments over at least a 10 year period or for the recipient's life or life expectancy.
- For annual installments, this would require 11 installments, since the 10th installment would be the 9th year after the first.

Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- The Code § 3121(v)(2) regulations expressly EXEMPT stock options, stock appreciation rights, restricted stock, severance, sick leave, compensatory time and vacation pay.
- Stock options, SARs, and restricted stock could not be paid out over 10 years or as an annuity in any event.
- Code § 409A has significantly limited application of this exception, by barring most changes in deferred compensation distribution schedules.

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Federal Blocker of State Taxation of Certain Retirement Income of Former State Residents, cont.

- Since Code § 3121(v)(2) applies to EMPLOYEES, it is not clear whether this provision applies to corporate directors or other non-employees (excepting certain retired partners who are covered by a later statutory expansion of this federal source tax legislation).

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Additional Specialized Federal Blockers of State Taxation of Transient Nonresident Workers

Congress has enacted several industry-specific laws that fully or partially block states from mandating withholding on wages of certain non-resident employees of certain types of employers:

- Railroads - 46 USC §11502 (4-R Act);
- Airlines - 46 USC § 40116 (Anti-Head Tax Act);
- Motor Carriers - 46 USC §14503;
- Fishing vessels, or vessels engaged in "foreign, coastwise, intercoastal, interstate, or noncontiguous trade." - 46 USC § 11108.

VIII. Hopes for Future Federal Blockers of State Taxation of Nonresident Workers

- “Telecommuter Tax Fairness Act” – first introduced in 2004, most recently introduced in Nov. 2011 (S. 1811, 112th Cong.) – would bar states from adopting a “convenience of the employer rule,” and require that an employee be physically present in the state as a precondition to imposition of tax on that worker.

Hopes for Future Federal Blockers of State Taxation of Nonresident Workers, cont.

- “The Mobile Workforce State Income Tax Simplification Act,” introduced in 2006 and 2009, was reintroduced most recently in 2011. (H.R. 1864, 112th Cong.)
- This bill would address the taxation of nonresident employees (excluding professional athletes, professional entertainers, and some public figures) and would set a threshold of days below which a state could not subject the nonresident to state income tax.
- The initial bills had proposed a 60-day threshold, but because of state clamor, a compromise was reached between employers and states, and in the most recent version of the bill, a 30-day threshold was proposed.

Hopes for Future Federal Blockers of State Taxation of Nonresident Workers, cont.

- In testimony before the House Committee on the Judiciary on May 25, 2011, the President of the Federation of Tax Administrators (“FTA”) opposed the bill, arguing that:
  - The 30-day rule should count work for any part of a day
  - A dollar threshold be added, so that highly paid employees might be subjected to withholding for under 30 days of work
  - Stock options and multi-year compensation be exempted
  - The House Judiciary Committee approved the bill on November 17, 2011, after rejecting changes proposed by Rep. Nadler (NY), but recognizing that changes may be required to respond to the FTA’s concerns.

Hopes for Future Federal Blockers of State Taxation of Nonresident Workers, cont.

- The Multistate Tax Commission has proposed a mobile workforce withholding and individual income tax model statute that would decrease the threshold to 20 days. The MTC's model statute provides that MOST nonresidents' income from work performed in a state of nonresidence would be exempt from withholding if the nonresident:
  - has no income derived from the nonresident state;
  - worked fewer than 20 days in that state (days in transit would be exempt from the day count); and
  - resides in a state that has a reciprocal exemption or does not impose a personal income tax.

Hopes for Future Federal Blockers of State Taxation of Nonresident Workers, cont.

- Certain workers would be excluded from the withholding protections provided by the MTC's model statute:
  - professional athletes;
  - persons of prominence who perform services on a per-event basis;
  - professional entertainers;
  - construction laborers; and
  - key employees.

Hopes for Future Federal Blockers of State Taxation of Nonresident Workers, cont.

- Under the MTC's model statute, qualifying employees would not have a filing requirement in the state of nonresidence; and employers would not have a withholding requirement regarding qualifying employees.
- However, the model act does not explicitly address nexus issues for employers with no nexus to the state.
- Also, states with "income thresholds" instead of day-counting thresholds (e.g., Montana) have criticized the MTC's model statute and its "days of working presence" test for creating problems for states that have an income threshold for taxability. They also note that high-earner nonresidents working less than 20 days would be exempt from filing returns, while lower-paid nonresidents working more than 20 days in a state would have to file.

IX. U.S. Taxation of Nonresident Alien Income

- Nonresident alien is subject to federal income tax only on income that is from "sources" within the U.S.
- Compensation for personal services performed in the U.S. is U.S.-source income
- Exception applies if all three of the following tests apply:
  - (i) the employer is foreign person not engaged in trade/business in U.S. or foreign office of U.S. entity;
  - (ii) the nonresident alien spends no more than 90 days in the United States in the calendar year; and
  - (iii) compensation for all work in the U.S. does not exceed $3,000.

U.S. Taxation of Nonresident Alien Income, cont.

- Treaty Exception: If the nonresident alien is an income tax resident of a country that has an income tax treaty with the U.S., an exemption from U.S. tax is usually available if the following three tests are met:
  - (i) the alien may not spend more than 183 days in the U.S. during the year;
  - (ii) his employer must be a non-U.S. person; and
  - (iii) the employee's salary cost may not be deducted by a permanent establishment that the employer maintains in the U.S.

U.S. Taxation of Nonresident Alien Income, cont.

- Under a few treaties an additional limited exception is available for work done by the treaty country resident in the U.S., where total salary for the year does not exceed a prescribed dollar minimum e.g. Article XV(2) of the U.S.-Canada Income Tax Treaty provides an exemption for salary of not more than U.S. $10,000 earned by a Canadian resident from U.S. employment.

U.S. Taxation of Nonresident Alien Income, cont.

- Sourcing rules:
  - Compensation generally allocated on the basis of workdays spent within and without the U.S.
  - Stock option income generally allocated on the basis of workdays between the date the option was granted and the date that it became vested.
    - *Treaty rules may vary*

U.S. Taxation of Nonresident Alien Income, cont.

- Withholding – required on U.S.-source compensation same as for a U.S. citizen
- "Employer" must withhold
- Employment taxes required unless totalization agreement applies

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