

# Multistate Withholding Tax: The Next Big Issue in State Tax Practice?

by Timothy P. Noonan



I've covered a lot of topics in this column over the years, ranging from personal income tax, residency issues, sales tax issues, to corporate tax questions, and so on. Those who know me — and, I suspect, regular readers of my column — understand that I don't always write because I have academic interest in a particular topic or issue.

Indeed, I find the tax law interesting, just not *that* interesting. So my columns generally involve more practical issues and are reactive — I'm reacting to issues I see every day in my practice. I'm reporting on changes in areas of tax practice that affect what I do on a daily basis. And often I'm complaining about something a state tax auditor said to me three days ago. Whatever the case, I like to think this practical aspect of my writings can often be helpful to the outside world.

Hence, this topic. Recently, with states seeing sales tax revenue down and incomes falling (with a corresponding loss of income tax revenue), they have been searching for new sources of revenue and new issues to audit. And one area in which there has likely been significant noncompliance historically relates to nonresident income tax, both on the payroll withholding side and the individual income tax side. With employees traveling across the country on behalf of their employers, issues of sales tax and corporate tax nexus aren't the only tax matters that arise. People working in a state outside their home state are creating income tax responsibilities for themselves and payroll tax responsibilities for their employer. Again, this wasn't an issue that historically generated a lot of attention. And why would it? If my employer was supposed to withhold Massachusetts tax for some Massachusetts work days, generally all that would mean is that it would withhold less New York tax from my paycheck and more Massachusetts tax. Similarly, as an individual I

might pay a couple of bucks to Massachusetts, but I still get a credit from my home state for the Massachusetts taxes paid. So the issue just never came up. But now it has. Now states see this as another source of revenue. And even though it might be a question of money changing hands between the various states, individual states don't care. That doesn't drive their individual audit selection policy.

So, true to form, because this is an issue that I've started to see, I thought I'd dedicate a column to it. In this article, I'll discuss multistate income tax allocation and withholding issues and explain why they are such a growing problem.

## Background

A couple of months ago *The New York Times* published an article on this growing problem.<sup>1</sup> The premise of the article was that states have always gone after some nonresidents — such as athletes, entertainers, and so on — for income taxes rising in connection with work performed in the state, but now that type of inquiry has extended beyond athletes to normal, everyday employees. As the article reports, the response by most companies is either to try mightily to comply despite the administrative burdens on their day-to-day business or just say “forget it” and wait for an audit. Whatever the case, the issue is getting headlines.

Here are the basics of the tax issue: A taxpayer who qualifies as a “resident” of a particular state pays tax on only one thing — *everything*. But nonresident taxation is based on a “source income” principle. In other words, states are entitled to tax income that has a source in their state. Wage income offers the easiest example. It has a source in a particular state, generally to the extent work is performed in that state. So if I live in New York but do all of my work in Pennsylvania, the source of my wage income is 100 percent Pennsylvania, and Pennsylvania can tax all of that income. If half my

<sup>1</sup>Catherine Rampell, “States Look Beyond Borders to Collect Owed Taxes,” *The New York Times*, Mar. 21, 2010.

work is done in Pennsylvania, half my income is sourceable to Pennsylvania. You get the idea.

That obviously creates issues for the individual. A taxpayer who lives in New York but works half the time in Pennsylvania clearly has a personal income tax responsibility to pay taxes to Pennsylvania on the Pennsylvania-source portion of their wage income. Of course, New York tax law allows for a credit for taxes paid to other states, so even if an employee went to the trouble of filing a Pennsylvania return and paying the tax, ultimately it would result in the employee having no net out-of-pocket cost because the New York credit would wipe out the taxes paid to Pennsylvania.<sup>2</sup>

**Issues for the Employer: Withholding Taxes**

But the issue isn't always as simple on the employer side. Whereas the employer is not required to pay income taxes on behalf of the employee, most states require some form of income tax withholding for wages paid to employees with source income in that state. And taken to its extreme, those withholding rules could require an employer to withhold personal income tax in every state where its employees work, even for periods of time as short as one day. That troublesome, headline-grabbing thought is likely one of the reasons this issue got swept under the carpet for so many years. It was just too ludicrous to address. But over the years, and more recently as states have stepped up education and enforcement, we're seeing many states applying threshold levels of contact before requiring employer withholding. And although many of those measures are well-intentioned, we once again have a problem in which there are multiple jurisdictions with many different rules applied in a variety of different circumstances. In other words, it's just another quagmire in the state and local tax area.

For instance, there are a number of states where an employer's withholding tax responsibility is limited to the number of visits by a particular employee in the state. Here's a quick summary:

State Name	Visits Threshold
Arizona	60 days
Connecticut	14 days
Georgia	23 days in a calendar quarter
Hawaii	60 days
Maine	10 days
New Mexico	16 days
New York	14 days

<sup>2</sup>See Tax Law section 620. Other states have similar credit provisions.

Other states have an income-level threshold, meaning that if an employee's wage income resulting from services performed in the state does not exceed a specific amount, no withholding is required. Here's a quick summary of those states:

State Name	Income Threshold
California	California wages are equal to or below the "low income exemption table"
Georgia	5% of total earned income or \$5,000
Idaho	\$1,000
New Jersey	In-state wages are less than the employee's personal exemption
Oklahoma	\$300 in a calendar quarter
Oregon	Oregon wages are less than the standard deduction
South Carolina	\$1,000
West Virginia	In-state wages below employee's personal exemption amount
Wisconsin	\$1,500

And of course, there are a variety of states that have no threshold, including Massachusetts, North Carolina, and Colorado.

These lists aren't intended to be exhaustive, nor do they hit at every threshold-type test in many different states. But they do provide a nice example of the quagmire many employers face in the multi-state withholding tax area.

The news isn't all bad, however. Some states have agreed to work together and have ventured into reciprocity arrangements with neighboring states. Under those arrangements, if two states have a reciprocal agreement, only the state where the taxpayer resides will be entitled to the tax. For example, Illinois and Iowa have a reciprocity agreement. So if I live in Illinois but work in Iowa, normally Iowa would get tax on my income (and Iowa withholding would be required) because my income is sourceable to Iowa. But Iowa and Illinois have agreed to let Illinois tax me because I live there. Obviously, it works both ways. There are lots of examples of states that have these types of agreements, including Kentucky, Ohio, and Pennsylvania. But again, not all states or combinations of states have this type of setup, so it makes the issue just as difficult for multistate employers.

**Constitutional Issues?**

Whenever you have employees traveling across state lines and working, constitutional questions are going to arise. Is it constitutional for a state to be able to tax an employee (and require an employer to withhold tax) just for a couple days work in the state? The answer is most likely yes. Certainly under constitutional law, states are allowed to tax

income that has a source in their state.<sup>3</sup> So the authority is there. Presumably there could be commerce clause implications, but it's unclear whether a withholding tax for an employee working in the state would fail any of the four commerce clause tests set by the U.S. Supreme Court in *Complete Auto Transit*.<sup>4</sup> So it appears that what the states are doing — or trying to do — likely would pass constitutional muster.

### Practical Considerations

But that doesn't mean what the states are doing is realistic. Requiring employers to withhold personal income taxes on employees who work a couple days in various different states across the nation doesn't make much sense from a business point of view. Unfortunately, though, with states stepping up withholding tax audits and looking at this issue on a multistate basis, many companies are forced to address it.

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Moreover, sometimes it's simply not just the risk of audit that creates the problem. In particular, with additional regulatory reporting requirements arising out of the Sarbanes-Oxley legislation as well as other government reforms, many public companies (and some private ones) are required to give certifications about their company's compliance with tax issues on a federal and state basis. That becomes harder if issues in the withholding tax area are known but not addressed.

### A Federal Solution?

Maybe. Legislation has been proposed in Congress to address this problem. Under H.R. 2110, the Mobile Workforce State Income Tax Fairness and Simplification Act (a title that is anything but simple), the following system has been proposed:

- **Employees subject to tax on all wages in state of residence.** All wages and other remuneration earned by an employee are subject to the income tax laws in the state of the employee's residence.

- **Uniform rule for taxation by nonresident states.** Wages and other remuneration are also subject to tax in the states within which the employee is present and performing duties for more than 30 days in a calendar year.
- **Exclusions from uniform rule.** The 30-day threshold does not apply to employees who are professional athletes, professional entertainers, or some public figures who give speeches or make similar-type appearances and are paid on a per-event basis.
- **Record keeping.** An employer may rely on an employee's determination of the time spent in a nonresident state absent knowledge of employee fraud or collusion between the employer and employee.
- **Definitions.** An employee will be considered present performing duties in a state if the employee performs the preponderance of his or her duties in that state for such day.

Under the current proposal, the act would be effective on January 1, 2011. But whether this type of legislation has any chance of passing is unclear. Certainly, the idea behind it is a good one — this is exactly the type of federal legislation that would solve the huge problem in the state and local tax area. But whether these issues take hold in Congress, particularly when it seems like lawmakers have bigger fish to fry — or whether the federal government should even be interfering in this area — is another story. That, thankfully, is a topic for a totally different article.

### Conclusion

As states continue to expand their efforts in the withholding tax area, tax practitioners will undoubtedly find themselves getting dragged in either to help on audit or help on a planning basis. And absent federal legislation, there might not be an easy answer or solution. Practitioners have to sit with their clients, figure out where their employees are going, and decide on practical solutions for achieving the best possible compliance on a multistate basis. ☆

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<sup>3</sup>*Shafer v. Carter*, 252 U.S. 37 (1920).

<sup>4</sup>*Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).