

REMOTE WORKERS AND STATE TAXATION



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The question of a state's imposition of nexus sufficient to exact taxes from a company, worker, or transaction involves significant constitutional inquiry. Such constitutional inquiry includes consideration of the Due Process Clause, the Commerce Clause, and equal protection principles. The key calculus is a balancing of the burden that taxation by a state exerts on interstate commerce with the important state interest that the taxation is intended to further. In striking this balance, courts will generally apply intermediate scrutiny (in other words, a similar level of scrutiny as courts utilize in examining content-neutral prohibitions on speech).

The Commerce Clause is set forth in Article I, Section 8 of the United States Constitution and authorizes Congress to "regulate Commerce with foreign Nations and among the several States, and with Indian tribes."

The so-called "Dormant" Commerce Clause arises from the Constitution's positive grant of authority to Congress, which in turn, has been interpreted as implicitly prohibiting states from interfering with or discriminating against interstate commerce.

In accordance with *Complete Auto Transit, Inc. v. Brady*, to pass constitutional scrutiny, state taxation of interstate commerce must:

- Tax only activity with a substantial nexus;
- Be apportioned fairly;
- Not discriminate against interstate commerce; and
- Be fairly related to the state's services.¹

Categories of taxes that states impose include:

- Taxes on income/business activities;
- Taxes on sales;
- Taxes on use of property; and
- Obligations to withhold taxes on payroll.

The Interstate Commerce Tax Act of 1959 prohibits a state from imposing or assessing a net income tax on income derived from within its borders from interstate commerce if the company's only business activity within the state is the solicitation of orders for sales of tangible personal property so long as the orders are sent outside the state for acceptance or rejection and, if accepted, are filled by shipment or delivery from outside the state.²

In *Quill Corporation v. North Dakota*, the US Supreme Court concluded that the presence in North Dakota of floppy disks (from which to upload software) shipped by the out-of-state seller constituted minimum contacts for purposes of satisfying the Due Process Clause.³ However, the Court continued, these minimum contacts were not enough because substantial nexus under the Dormant Commerce Clause requires physical presence.⁴

Nexus without physical presence

However, in *South Dakota v. Wayfair, Inc.*, the Supreme Court overturned *Quill* and *National Bellas Hess v. Dept. of Rev. of Ill.*, and upheld a South Dakota law that imposed a sales tax on remote sales.⁵ The Court determined that a sufficient economic nexus existed between the state and the taxed activity for South Dakota to collect sales tax on out-of-state sellers with \$100,000 in taxable sales or 200 separate transactions in South Dakota. To be clear, physical presence on the part of the seller is no longer required.

Nexus with physical presence

The answer may change, however, if an employee is "physically" present in a state by, for example, working remotely. As background, the Interstate Commerce Tax Act does not apply if a worker is simply soliciting sales. Hence, income tax economic nexus may be established.

Furthermore, if a set sales/transaction threshold is met, even without the physical presence of a remote worker, then the obligation to collect sales tax is established. What is more, the duty to withhold income tax generally arises in the place where an employee performs services and/or resides; accordingly, a company would then also have a withholding obligation.

Guidance from Multistate Tax Commission

On October 17, 2002, the Multistate Tax Commission issued the Factor Presence Nexus Standard for Business Activity Taxes (Factor Presence Nexus Standard). Under paragraph B(1), "[s]ubstantial nexus is established if any of the following thresholds is exceeded during the tax period":

- A dollar amount of \$50,000 of property; or
- A dollar amount of \$50,000 of payroll; or
- A dollar amount of \$500,000 of sales; or
- Twenty-five percent of total property, total payroll, or total sales.⁶

Among the jurisdictions that have adopted the Factor Presence Nexus Standard are:

- Alabama;
- California (including San Francisco);
- Colorado;
- Connecticut;
- Hawaii;
- Massachusetts
- New York;
- Ohio;
- Oregon;
- Pennsylvania (including Philadelphia);
- Tennessee; and
- Washington.

Indeed, some of these jurisdictions adopted the Factor Presence Nexus Standard even before the

Supreme Court approved the South Dakota standard in *Wayfair*.

Furthermore, the protections that the Interstate Commerce Tax Act would otherwise interpose do not apply if the commodity sold into a state is not tangible personal property. Accordingly, sellers of services or intangible property, such as software applications, would not benefit from the law.

Nexus with employee physical presence

Do the duties carried out by a remote employee make a difference? There has been a traditional legal argument that in-state employees whose duties do *not* contribute to the company's sales or product development functions (i.e., the "back office") should not create a nexus for imposition of income/business activities taxes. Examples of such a role include a company's payroll manager or a consultant for a company's internal software applications with no outside contact with potential customers. In light of *Wayfair* and the Factor Presence Nexus Standard, is this argument still a viable one?

Another issue raised by the in-state physical presence of a remote worker is the effect on apportionment. Many states have adopted the Uniform Division of Income for Tax Purposes (UDITPA)–Model Compact Article IV, Division of Income (as revised by the Multistate Tax Commission July 29, 2015). The factors considered under the UDITPA are:

- Payroll;
- Property; and
- Receipts/Sales.⁷

For states that have adopted the UDITPA, an increase in in-state payroll will mathematically result in an increase in the portion of total apportionable income that is allocated to that state. Generally, therefore, the relevant inquiry focuses on determining where the work was performed.

Consequently, if an employee telecommutes regularly from home, then the state of residence/domiciliary has a right to enforce the duty to withhold

and an entitlement to payment of an employee's state income tax. Factors for determining the domicile state include voter registration, vehicle registration, driver's license, bank location, doctor's office, real property, passport address, wills and trusts, days in-state/contact periods (e.g., 183 days or 212 nights).

The work duties of some employees, including consultants, auditors, drivers, sales professionals, and technical experts require substantial travel among various states. Some tools for determining the locations where such work is performed include tracking the locations of cell phones and other electronic equipment, requiring daily check-in, and scrutinizing expense reports and receipts with data mining techniques.

Nexus regardless of where work is performed

Five states have implemented a convenience of the employer rule: (i) Connecticut; (ii) Delaware; (iii) Nebraska; (iv) New York; and (v) Pennsylvania. Moreover, two states are imposing convenience of the employer treatment to protect revenues during the pandemic: Massachusetts and New Hampshire.

Under the convenience of the employer rule, a remote employee's wages are sourced to the employer's location unless it is demonstrated that the employee's remote work is necessary for the employer rather than for the convenience of the employee. An employee working at a remote location must still pay income tax to the state of residence in the absence of a reciprocity agreement with the employer's state. What is more, most of the states that apply a convenience of the employer rule will *not* extend credit for taxes paid to other jurisdictions and are not party to reciprocity agreements. New York, as an example, has published a Frequently Asked Questions (FAQ) page which references a 2006 Technical Bulletin, TSB-M-06(5)I and sets forth as a primary factor the existence of essential "special facilities" located near the employee's remote location that are not available near the employer's place of business.⁸

In *Zelinsky v. Tax Appeals Tribunal of State of New York*, the New York Court of Appeals held that imposition of the convenience of the employer rule to source to New York the wages of a Cardoza Law School professor who telecommuted from Connecticut comported with both the Due Process Clause and the Commerce Clause; any other outcome would enable the professor to avoid taxes that his faculty colleagues who did not telecommute would pay, the court reasoned.⁹

Pathways for relief during the pandemic

In view of the historic and pervasive nature of the disruption caused by COVID-19, Massachusetts, Rhode Island, South Carolina, and New Jersey have made it clear that nexus both for corporate income tax and sale/use tax purposes will not be established solely because of employees working remotely during the pandemic.

In addition, California, Iowa, and North Dakota have made it clear that nexus relief will apply only for corporate income tax, while Maryland and Kentucky consider nexus relief on a case-by-case basis.

In all instances, nexus relief will expire at a date linked to the expiration of the COVID emergency.

Long-term relief from nexus confusion

A frequently expressed hope has been for federal legislation to resolve the confusion regarding state-by-state nexus issues, especially in view of COVID-19. Although the American Rescue Plan of 2021 did not address nexus concerns, in June of 2021, Representative James Himes introduced the Multi-State Worker Tax Fairness Act of 2021 which establishes a uniform standard based on physical presence in a state. In doing so, the bill restricts a state from taxing

a nonresident's income earned when the individual was not physically in that state.¹⁰

Examples of earlier unsuccessful congressional efforts include:

- The Remote and Mobile Worker Relief Act of 2020, which would allow wages to be taxed only by states of residence or states where an employee works for more than 30 days (90 days during pandemic);¹¹ and
- The Multi-State Worker Tax Fairness Act of 2020, which would restrict states' ability to tax non-resident telecommuters—employees who would be statutorily deemed not to be present in one state while working from home in another state.¹²

Special challenges of remote working for law firms

While facing the same challenges that confront other employers, law firms, by virtue of their partnership-based organizational structures and high degree of regulation, are confronted with additional burdens. These distinct challenges appear both in the cultural and the tax and regulatory realms.

In the cultural realm, for example, these challenges involve supervising work productivity, mentoring and development, client interaction, and providing effective advocacy in the venue of virtual proceedings.

The tax and regulatory challenges include creating unintended nexus, the consequent complications of determining partnership allocations, and exposure to unfamiliar licensure issues and bar counsel. 📌

Notes

1 430 U.S. 274 (1977).

2 P.L. 86-273, 15 U.S.C. §§ 381-384.

3 504 U.S. 298 (1992).

4 See also *National Bellas Hess v. Dept. of Rev. of Ill.*, 386 U.S. 753 (1967).

5 138 S. Ct. 2080, 2099 (2018).

6 Factor Presence Next Standard for Business Activity Taxes, Multistate Tax Commission, available at https://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FactorPresenceNexusStandardBusinessActTaxes.pdf.

- 7 Model Compact Article IV, Multistate Tax Commission, available at <https://www.mtc.gov/getattachment/Uniformity/Article-IV/Model-Compact-Article-IV-UDITPA-2015.pdf.aspx>.
- 8 Frequently Asked Questions about Filing Requirements, Residency, and Telecommuting for New York State Personal Income Tax, N.Y. Dep't of Taxation, available at <https://www.tax.ny.gov/pit/file/nonresident-faqs.htm#telecommuting>.
- 9 801 N.E.2d 840 (N.Y. 2003); see also *Huckaby v. New York State Div. of Tax*, 829 N.E.2d 276 (N.Y. 2005).
- 10 H.R. 4267 (117th Congress 2020-21), available at <https://www.congress.gov/bill/117th-congress/house-bill/4267>.
- 11 S. 3995 (116th Congress 2019-20), available at <https://www.congress.gov/bill/116th-congress/senate-bill/3995>.
- 12 H.R. 7968 (116th Congress 2019-20), available at <https://www.congress.gov/bill/116th-congress/house-bill/7968>.