

Employment Tax Withholding Compliance

Sorting Through a Patchwork of Laws

By Jeff Friedman and Charlie Kearns

Nearly all large companies have workers traveling throughout the country. These traveling employees create a state and local tax obligation for companies—nonresident personal income tax withholding obligations—with which even the largest and most sophisticated companies struggle to achieve adequate compliance. Because a failure to accurately withhold state income tax on traveling executives will directly impact the employees' personal income tax obligations, companies' executive teams often are directly impacted by this tax compliance challenge.



Compliance Obstacles

States' withholding tax laws are a patchwork of laws, making full compliance difficult for multistate companies. Many states have low thresholds for determining when a company must begin withholding income tax on a traveling employee. For example, New York State requires employers to withhold tax from the wages of nonresident employees that work in the state after only 14 work days.

Ambiguous rules are another obstacle to companies trying to comply with nonresident withholding tax laws. For example, many states adopt a dollar threshold as opposed to a days worked threshold. Dollar thresholds create uncertainty for employers. It may be difficult for employees to estimate the amount of income that will be earned in a year, a necessary metric in determining whether to activate withholding in a state, much less attribute that income to a particular day. Companies struggle with creating systems and processes that can accurately capture and record the necessary data to report nonresident withholding tax.

Proposals to Simplify

To modernize and simplify state withholding tax compliance and enforcement, two competing proposals are being offered. Last year, with the support of various employers and trade groups, federal legislation H.R. 2110, the Mobile Workforce State Income Tax Fairness and Simplification Act, was introduced. If signed into law, H.R. 2110 would establish a national framework for states to require an employer to withhold tax from a nonresident employee's wage or nonwage payments attributable to service performed in a state. Partially in response to this legislation, the states, working through the Multistate Tax Commission (MTC), are developing a model withholding state statute. The model statute is an attempt to encourage states to voluntarily adopt uniform withholding tax rules.

Multistate Tax Commission

MTC is an intergovernmental state tax agency that, among other things, drafts model state tax laws. For more information on the MTC, visit www.mtc.gov.

Although the MTC draft and H.R. 2110 are topically similar, they contain very different provisions. Each proposal adopts a threshold number of days that a nonresident employee must work in a state before the employer must withhold personal income tax. Wages earned for service below the respective thresholds are excluded from withholding. H.R. 2110 requires in-state service of 30 days during a calendar year. The MTC draft requires only 20 days before withholding is required.

Both proposals provide the same significant benefit—nonresident wages excluded from withholding are also excluded from the nonresident employee’s personal income tax. As such, not only is the employer relieved of withholding obligations, but also the employee is relieved from filing income tax returns in potentially numerous states. Although the employee’s tax liability may not increase due to credits for taxes paid on the resident state’s return, the employee is spared the administrative headache of filing returns in numerous states. For this reason, making employees’ income tax filing thresholds identical to employers’ withholding tax thresholds is a crucial element in crafting a national framework for taxing mobile employees.

Matters for Consideration

Because H.R. 2110 and the MTC proposal both necessitate counting days for each involved employee, it is important to determine what constitutes a “day” for purposes of the respective thresholds. The MTC draft provides that any portion of a day worked in a state equals a full day towards the 20-day threshold. In contrast, the federal legislation adopts a much more reasonable “preponderance” of a day test to allocate wages to a state.

Finally, it is notable that the current MTC draft contains a number of exceptions to the 20-day safe harbor. Most notably, its coverage excludes certain “highly compensated employees” and “key employees.” Although the exclusions reduce the number of employees obligated to withhold nonresident income tax, these carve-outs significantly undermine the simplification of the MTC proposal. H.R. 2110 does not contain any similar limitations and, therefore, may ultimately be simpler to implement.

The MTC draft will likely be expedited for approval in light of the looming federal bill and could be finalized as early as March 2010 for consideration at the MTC’s July 2010 meeting. The passage of H.R. 2110 is difficult to predict. In the meantime, employers may wish to consider developing and putting in place withholding tax policies and communicating those policies to employees.

H.R. 2110	MTC Proposal
Supported by various employers and trade groups	Developed by the states working through MTC
National framework for states to require an employer to withhold tax from a nonresident employee’s wage or nonwage payments attributable to service performed in a state	Model withholding state statute to encourage states to voluntarily adopt uniform withholding tax rules
Nonresident wages excluded from withholding are also excluded from the nonresident employee’s personal income tax	Nonresident wages excluded from withholding are also excluded from the nonresident employee’s personal income tax
30 day threshold	20 day threshold
Preponderance of a day test to allocate wages to a state	Any portion of a day worked in a state equals a full day toward the threshold
No similar exclusions	Contains exceptions for highly compensated employees and key employees to the 20-day safe harbor
Difficult to predict passage	Likely to be expedited for approval and could be finalized as early as March 2010

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