State Payroll Taxes Need Remote Work Reforms

By **Samuel Parks, Christie Galinski and Gregory Nowak** (May 15, 2023)

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Remote work has never been so salient for America's employers and employees. However, many employers and most employees are unaware of state tax laws for remote workers. And some employers, particularly small businesses, are aware but find compliance so cumbersome that they choose to ignore it.

The current situation of state payroll taxes on remote workers is one of confusion. Each state treats each type of tax differently, and many states have additional taxes or variations of these taxes.

Hiring a remote worker in another state could trigger employer liability for tax compliance in the new state, including state payroll income tax withholding, state unemployment tax withholding, state sales taxes and state business taxes.

In addition, some businesses faced with a confusing and costly compliance regime will fail to comply with the state taxes, especially when they have few employees in a state. The challenges of identifying those taxpayers and bringing them into compliance may not justify the state's enforcement efforts.

In March 2020, most states provided employers initial relief from tax compliance for their remote employees. But these pandemic-related relief provisions have sunset, so employers might be surprised with a tax bill or audit for the 2022 tax year.[1]

States would like to attract well-paid workers from elsewhere in the country.[2] To do so, they should consider becoming more competitive by reducing compliance costs.

Payroll Taxes — One Worker for One Day

Most states require payroll tax compliance when a company has even a single employee performing services in the state,[3] so remote workers almost certainly create compliance burdens with payroll taxes.[4] States can require withholding of payroll taxes by the employer if even a single day of work is done in the state.

However, some states allow an employee to work remotely for an employer outside the state, for a limited number of days without a payroll withholding requirement. For example, Illinois allows for 30 days of remote work before withholding is required.[5]

Before COVID-19, the issue of mobile workers, a worker traveling to another state to work, was more common than remote workers — employees working from home. To address mobile workers, some states entered into reciprocity agreements with nearby states.

Under these agreements, a mobile worker is only subject to taxation and withholding in their state of residence. Although many state governments will provide tax credits for income taxes paid to other states, these tax credits do not reduce compliance burdens, as employers are required to withhold taxes, and employees are required to file tax returns, with both states.

The current compliance burdens of these various state taxes may be too much for small and medium-sized employers who would like to attract remote workers and grow a larger talent pool.[6]

Currently, the costs of hiring a remote employee or allowing an existing employee to work remotely, which reduces turnover, includes:

- Discerning whether the remote employee triggers any filing and reporting requirements;
- Determining the sales and corporate tax liability and registration requirements; and
- Creating withholding, unemployment and business tax accounts in each state by adhering to myriad processes and filing many forms, unique to each state;[7]

Once the employee is hired, every year, the company will need to:

- Calculate how much of each tax is owed, based on formulas that vary by state;
- File information returns and tax returns for each state for each type of tax; and
- Recalculate apportionment factors to include the new state with a single employee.[8]

If this sounds like a lot, it's because it is.

The weight of this costly compliance is not limited to employers paying employment taxes. States police an increasingly complex system and companies must often project future revenues to determine whether they are also subject to other state taxes.[9]

For example, in the sales tax realm, California increased its sales tax nexus threshold from $100,000 to $500,000 in gross receipts.[10] The state concluded that enforcement at the lower threshold amount actually reduced its tax income due to administrative and enforcement costs.[11]

Moreover, employers frequently risk noncompliance when they have minimal employees in a state, further adding challenges to states and employers. A common example would be an employer who has a single employee in a state, who moved there to work remotely during the pandemic, and continues as though that employee was located in their original state.

"For the Convenience of the Employer" Rules

Some states like New York, and cities that impose city payroll taxes, have aggressive "for the convenience of the employer" rules related to payroll tax withholding, which can pose additional challenges by subjecting remote workers to tax not only where they live but also where their employer is based.[12]

Employers in New York can be required to withhold payroll taxes for employees working outside the state unless the work is performed remotely for the convenience of the employer.[13] These rules can lead to employers withhold payroll taxes for two states, the remote work state and a state with this rule.

States that are losing employees to remote work will certainly seek to retain their tax base as they lose employees, efforts that may include more aggressive taxation of employees working outside their state.

States Should Reduce Compliance Costs for Remote Workers

As the norms and practices around work evolve, current tax regimes will need to adjust to this new reality. This adjustment will take time, as did implementation of tax reciprocity. For example, the first reciprocity agreement Michigan entered with Wisconsin was effective Oct. 1, 1967, with additional states added in 1968, 1971, 1972 and 1984.[14]

Given the recent overnight change to remote work, confusion in the current regime is to be expected. That said, there are some adjustments states can make to reduce compliance burdens. Also, lawmakers should consider what may help their states compete for top talent currently living in the country's biggest cities.

Some policy solutions mutually benefit both the state and employers. Additionally, some cooperation between states appears prudent, given the zero-sum nature of income taxation at the state level.

First, states should look to simplify the process of registering for payroll taxes by out-of-state employers with remote employees. This will increase compliance and decrease the employers' costs.

Second, states that have not done so should consider specifying a minimum number of days of work allowed before employment taxes apply. For example, Illinois allows workers to work inside the state for up to 30 days before withholding is required. This should reduce worries for remote employees temporarily staying in another state.

Third, states should consider entering into reciprocity agreements with other states for remote workers as they do for mobile workers. These agreements should aim to clarify and simplify rules related to remote workers in order to increase compliance, reduce employer burdens and share income tax revenue. For employees and employers, the simplicity of requiring compliance with only one state's tax rules would be ideal.

States that become friendlier to remote work will not only reduce compliance costs for employers and employees, but also encourage higher-paid and highly skilled employees to remain in the state rather than relocate. This would help local economies and substantially reduce state administrative costs of payroll withholding enforcement.

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[1] Zachary T. Payne, Rise in Remote Complicates State Payroll Withholding Taxes for Workers, GT Reilly & Co., (Oct 25, 2021), https://www.gtreilly.com/newsletters/article/rise-in-remote-work-complicates-state-payroll-withholding-taxes-for-workers.

[2] For additional background on the state of remote employee, see Ryan Golden, Most US Employers with Flexible Work Plans Choose Hybrid Work, Mercer Says, HR Drive (Jul. 14, 2021), https://www.hrdive.com/news/most-us-employers-with-flexible-work-plans-choose-hybrid-work-mercer-says/603304/; Statistics on Remote Workers That Will Surprise You (2022), Apollo Technical (May 11, 2022), https://www.apollotechnical.com/statistics-on-remote-workers/.

[3] Paul Jones, Remote Work Complicates Employer Tax Compliance, Pressures States to Revise Rules, Taxnotes (April 5, 2022).

[4] Id.

[5] Publication 130 Who is required to Withhold Illinois Income Tax August 2022 Illinois Department of Revenue.

[6] Jones, supra note 3.

[7] Id; Blair Murphy, Remote Workers Create State Tax Issues That Can Impact Company Value, Ernst & Young (Apr. 8, 2022), https://go.ey.com/3jhJg6t.

[8] Id.

[9] Steve Wlodychak, Retired Principal, Ernst & Young LLP, Plenary Session at ICLE 34th Annual Tax Conf, The "Crossroads of Nexus" (May 26, 2022).

[10] California Assembly Bill 147 for 2019. See also https://www.calcities.org/news/post/2019/05/01/ab-147-california-s-new-online-sales-tax-collection-law-what-cities-need-to-know-25852 (May 4, 2023).

[11] Wlodychak, supra note 9.

[12] Amy Hodges, New York Remote Work Rules Clash With COVID-19 Realities, Experts Say, Taxnotes (Jan. 24, 2022), https://www.taxnotes.com/featured-news/new-york-remote-work-rules-clash-covid-19-realities-experts-say/2022/01/24/7d451.

[13] Id.

[14] MI RAB 1988-

17, https://www.michigan.gov/treasury/reference/rab/content/1988/revenue-administrative-bulletin-1988-17.