The Conundrum of State Income Taxes for Road Warriors

If you think that the federal tax rules are complicated, state and local tax rules can be even more perplexing, especially for those who travel for work – so called “road warriors”. The state in which an individual is a permanent resident has the right to tax all of the individual’s income, regardless of where earned. Then, if that individual works and earns income in another state, he or she may have to file a nonresident income tax return and pay taxes in that state, depending on a number of factors.

Of the 41 states and the District of Columbia (D.C.) that impose an income tax on wage income, nearly all have laws that subject nonresidents to tax on income earned while working in the state. Generally, wages are apportioned based on a ratio of days worked in the state over the total of days worked. However, due to resident state tax credits, this doesn’t necessarily mean that “road warriors” will have to pay more total state income taxes.

But state taxation rules are not uniform, often can be confusing, and are subject to change. For example, seven states passed legislation or announced changes to their tax rates or tax brackets this past June or July. NC announced a rate change effective for 2019. IL and KS enacted retroactive tax rate increases, while ME (whose voters had approved an increase in the rate for those with income above $200,000), eliminated its new highest tax bracket following a 3-day government shutdown. Two states (NH, TN) currently tax only interest and dividends and not wage income. CT had a similar rule taxing only interest, dividends and capital gains until 1991 when it began to tax wage income. Eight states have a single tax rate while 33 states and D.C. have anywhere from 2 to 12 income brackets.

There also are 15 states and D.C. that have reciprocity agreements with neighboring states. These permit an individual to file and pay taxes only in their state of residence. For example, someone who works in IL but lives in IA, KY, MI or WI does not have to file or pay IL income taxes if they submit Form IL-W-5-NR to their employer. NJ and PA have a reciprocity agreement that has been in place for more than 40 years, although it covers only employee compensation. Thus, someone who is self-employed or who receives income from other sources (e.g., sale of real property) would need to file a return and possibly pay taxes in both states.

Road warriors, as well as commuters (those who live in one state but work in another), may have to deal with filing income tax returns in multiple states. However, two states cannot tax the same income, based on a 2015 U.S. Supreme Court decision (Wynnes vs. Maryland). The Court ruled that Maryland’s local tax on out-of-state income violated the Interstate Commerce Clause of the Constitution. Whether an individual is considered to be a resident versus a nonresident varies by state. This complexity has resulted in some individuals ignoring nonresident filing requirements, especially when no tax withholding occurs.

Members of the military and their spouses are now exempt from owing taxes in the state where they are temporarily stationed. Similarly, exemption rules can apply to students who attend college out of state. Twelve states now have laws exempting from nonresident taxation emergency-response workers in the state due to a declared disaster.
State Income Tax History
The earliest taxes in North America were assessed by Plymouth Colony and the Massachusetts Bay Colony on farmland produce beginning in the 1640s. After the American Revolution, several states began assessing customized taxes. PA introduced a tax on bank dividends, paid through withholding, in 1835. Beginning in the 1840s, several states, including PA, MD, AL, VA, FL and NC began taxing elements of income, which was collected by local elected officials (so you can imagine where it ended up). Then, during the Civil War era, both the Union and Confederacy instituted income taxes, as did several states – TX, MO, GA, WV, LA, KY. But all abolished their taxes after the war and a 1895 Supreme Court decision effectively ended the federal income tax.

The current federal income tax on wage and certain other income was adopted just over one hundred years ago in 1913. Prior to that, two states – Mississippi and Wisconsin – had adopted their own state income tax (Hawaii also had its own tax, but it didn’t become a state until 1959). Ten other states adopted an income tax prior to 1920. Individual income taxes account for approximately 36% of state tax revenue today.

State Tax Rules & Procedures
Most states follow the federal rules for determining taxable income and allowable deductions. But this is not universally the case, especially with regard to retirement income (to be further described below). The only income that states are prohibited from taxing is from federal bonds, bonds of U.S. territories or other federal obligations.

Each state administers its own tax system. States with the highest tax rate for residents include CA, OR, MN, NJ, VT and NY. The seven states with no income tax include AK, FL, NV, SD, TX, WA, and WY. Some states have special rules for nonresidents who receive income from state sources. LA and ME only require nonresidents who must file a federal tax return to file a nonresident return (subject to certain exceptions). MA has different filing thresholds for residents versus nonresidents. NC requires that a copy of the federal tax return be included with the NC return if the return does not show a NC address. A person who resides outside NY but who has a “permanent place of abode” and spends more than 183 days in NY is considered a NY resident – and thus subject to NY tax on all income.

States that have a separate tax rate for married taxpayers now must treat legally-married same-sex couples the same as opposite-sex couples following a raft of court decisions. Prior to the Supreme Court’s Obergefell decision in 2015, same-sex couples could have been required to file as single individuals in some states but as married in others, creating a dilemma when required to file returns in multiple states. Obergefell also created an opportunity for same-sex married couples to file an amended tax return (federal and state) for tax years prior to 2015.

With many states searching for additional revenue and now armed with better technology to track individuals that travel for work, we have seen a significant increase in enforcement by some states of their tax rules. This is especially true for higher-paid and higher-profile executives (as well as athletes and entertainers). In the 2016 Payroll Tax Compliance Survey by Bloomberg BNA and Ernst & Young, 35% of surveyed employers with mobile domestic workers indicated they had been audited for state tax withholding. The states conducting the greatest number of audits were NY, CA, PA, NJ, NC and OH. NY auditors have been reported to collect over $200 million each year in residency audits. The NYS nonresident audit guidelines are over 120 pages long - let us know if you would like a copy.

While virtually all companies agree that it is the employee’s responsibility to file returns and pay taxes in jurisdictions when required to do so by state law, companies are taking a fresh look at their responsibilities with regard to mobile employees. Precipitated by risk avoidance concerns and taking into account the increased vigilance and more effective enforcement by state tax authorities, more companies are reporting compensation among states in which an employee performs services, as well as bifurcating their state tax withholding.

An issue that has popped up in recent years is whether work from home or telecommuting is to be considered in calculating nonresident state taxes. In the 16th Annual Survey of State Tax Depts., 42 jurisdictions indicated they believe that telecommuting would provide a nexus for possible state taxation. And what counts as a day worked in a nonresident state? Would attending a technical conference or a corporate social event with a little work sprinkled in count as a work day? It depends.

Different Elements of Compensation – Different Rules
In determining the income taxes an employee may owe to a nonresident state and, also the amount that an employer is required to withhold, it’s not just salary that may be subject to allocation, but also annual bonus, long-term performance plan awards (when taxable) and other elements of pay, such as severance. The rules for many states are not perfectly clear. The correct allocation of compensation earned over a number of years, such as for stock option, restricted stock,
RSU and performance awards can be particularly challenging. For example, should stock option income be allocated to a nonresident state based on days worked there in the year of exercise, or for the year of grant, or from grant date to the vesting date?

CT looks at days worked in the state during the period from the year of grant through the end of the year of exercise. In NY, equity awards are taxed based on a ratio of days worked in NY over all days worked from the date of grant to the date of vesting. Nonresident taxpayers who receive pay for work within NY are to allocate income associated with nonqualified stock options, SARS, restricted stock and RSUs. In contrast, to NY’s rule, NC allocates income based on a multiyear fractional method regardless of residency status when options are exercised. CO allows an allocation based on time worked in the state.

Compensation that is earned in one year or over a period of time and paid in a subsequent year is often characterized as “trailing compensation”. State laws can sometimes be unclear as to how such compensation is taxed for nonresidents and part-year residents (i.e., those that relocate during the year). For example, an annual bonus paid the calendar year after it is earned often is subject to tax in a nonresident state for the year earned. But the rules for state taxation may vary from city/local rules. As an example, the IN Dept. of Revenue concluded that an annual bonus earned in the state and paid when the individual is no longer a resident is subject to state tax and tax withholding, but IN county taxes would not be due in that situation.

Compliance with various state rules is generally higher for employees on temporary assignment than for business travelers. With employers required to use a Code V on Form W-2 to report stock option income, state tax authorities have a resource to be able to monitor equity income realized by former residents and business travelers. However, over 40% of companies surveyed in the 2016 Bloomberg BNA/E&Y Survey stated they did not source trailing compensation to the state earned when determining tax withholding.

Retirement Income
A large majority of states also have distinct and separate rules for the taxation of retirement pay. At least 29 states provide a full or partial exclusion for retirement plan payments and only 15 states subject some or all Social Security benefits to income tax. Ten states do not tax income from government pensions. Pennsylvania is unique in a sense since it does not subject any retirement income to state income tax. (But this can create a tax preparation allocation headache for someone who works in both PA and NJ or another state).

There are federally-imposed restrictions that can impact state taxation of employer-sponsored qualified retirement plan benefits and certain nonqualified deferred compensation arrangements. Under the Federal Source Tax Exclusion law enacted in 1991 (which is not part of the Internal Revenue Code), states are prohibited from taxing nonresidents on distributions from any qualified retirement plan or any nonqualified “mirror” plan, regardless how or when paid. (Whether a plan meets the definition of a mirror plan can be determined by each state’s tax department.) In contrast, other nonqualified deferred compensation, including “top-hat” plans and any NQ plan that is not found to be a mirror plan, may be taxed by a state in which the compensation was earned UNLESS the payment terms meet certain requirements. For this limitation to apply, payments must be scheduled to be made in substantially equal amounts over the lesser of life expectancy or a period of at least ten years. This creates a tax planning opportunity for those individuals planning their retirement to a state with no income tax – but here’s also where IRC §409A rears its ugly head.

Tax Withholding
At least 19 states have specific rules that require an employer to withhold taxes for a nonresident who performs services in the state based either on a minimum number of days worked in the state or on an income earned threshold. For example, withholding is required in MD once state-source wages exceeds $5,000. In WI, the threshold is $1,500 and it is $1,000 in ID. CA ties the dollar threshold to its lowest income exemption table, which takes into account an individual’s filing status. NY and CT generally only require withholding if a nonresident performs services in the state for more than 14 days. NM has a 15-day rule; AZ and HI have a 60-day rule. In GA, an employer must withhold if a nonresident is in the state for more than 23 days in a year or if at least 5% of total income or $5,000 is earned in GA. In CO, based on a Dept. of Revenue letter ruling, employers are required to withhold on behalf of anyone who performs work in the state for at least one day. Time spent traveling to CO counts as time worked in the state, but time spent traveling out of state does not. There are another 20 states that have no specific or clear rules regarding required withholding for nonresident wage earners.

Meanwhile, there are 33 states that have a distinct or flat withholding rate for supplemental wages, including annual bonuses and long-term incentive pay. These range from
1.84% in ND to the highest of 9.9% in NJ (but only for supplemental wages above $500,000) and 10.23% in CA (but only for bonus and stock option income).

Changes in state tax rates can pose challenges to employers, especially mid-year changes. An increase in tax rates can also increase the chances of individuals owing penalties for underpayment of taxes due. Several surveys have confirmed that a majority of companies still do not consistently follow the nonresident state tax reporting and withholding rules applicable to road warriors.

Cities & Counties that Levy Income Tax
Fourteen states allow cities, counties and other entities to levy their own income taxes on individuals who live or work within their boundaries. These taxes are in addition to any state taxes payable and typically are reported on a state tax return filed. In some cases, the tax for nonresidents is less than that for residents – for example Detroit’s is 2.5% for residents and 1.25% for nonresidents. In Philadelphia, the rate is 3.8907% for residents and 3.4654% for nonresidents. Last month, NYC’s Mayor proposed increasing the city’s highest tax rate from 3.876% to 4.41% for resident taxpayers with income above $500,000 ($1M for couples) to be used for public transportation repairs. States allowing these income taxes include: AL, AR, CO, DE, IA, IN, KY, MD, MI, MO, NY, OH, OR, and PA and D.C. All counties in IN and MD have such a tax, while all schools districts in IA, but only 7 in AR have a tax. In OH, 235 cities and 331 villages have an income tax ranging from 0.4% to 3%.

Withholding for city and local taxes can be a challenge for employers, especially for those employees who travel for work or who relocate. Just to illustrate, New York City does not require tax withholding for nonresidents, but Yonkers, NY does. Philadelphia requires tax withholding for residents and nonresidents by employers who are based in PA – but not those based out of state. Employees who do not have tax withheld must register for an Earnings Tax account.

Tax Assistance From Employers
While almost all companies leave it up to each employee to file and pay taxes as appropriate, a number of companies provide incentives to road warriors. Several companies reimburse executives and sometimes other employees for the cost of filing additional state tax returns due to business travel. This is similar to how companies have reimbursed employees for work-related relocation expenses, or certain expenses incurred by expats, or those road warriors who must travel overseas. We also have seen companies agree to reimburse state taxes incurred by an employee who lives and works in a state with no income tax and who is asked to spend time working in a state that does impose an income tax on nonresidents. Most states allow a credit against state taxes owed in the state in which they reside for any taxes paid to another state. Thus, allocating and paying taxes in multiple states generally will not result in duplicate taxation of the same income.

Company Policies
Exactly how business travel records are being kept and income allocated varies tremendously. Some companies use corporate travel records to allocate compensation and determine state withholding. Others use payroll records or information collected by administrative assistants. A practical problem is that many payroll systems have not been built to allow withholding in multiple states. At least six companies whose executives we work with have instituted changes in the past year with respect to their allocation and reporting of state income taxes for employees who are expected to travel to certain states. If you would like to see sample corporate communications explaining the reason for these changes and how they are being monitored, e-mail us.

Periodic reviews of company reporting and tax withholding policies can help ensure compliance with state tax rules and, in fact, may help executives more efficiently make all required state tax payments. A company’s agreeing to withhold taxes in multiple states also can help an executive more properly allocate tax liability. Instead of being overwithheld in the resident state (subject to claim for refund) and having to make additional tax payments to the nonresident state via estimated payments or at tax filing, withholding is allocated where taxes are due. We haven’t even broached the subject of foreign taxes here. That’s for another day.

Proposal for Uniform State Tax Rules
Federal legislation was proposed in 2013 that would allow states to tax and impose withholding requirements only on behalf of nonresidents who perform services in the state for more than 30 days during a calendar year. The basic premise of this bill was that a uniform state tax system would ease the regulatory burden on employers and could actually increase the ability of states to collect taxes on nonresidents. However, Congress never acted on the 2013 proposed bill. Earlier this year, Congress resuscitated the concept in the Mobile Workforce State Income Tax Simplification Act of 2017. It is currently before committees in both the House and Senate – although any Congressional action this year appears unlikely.
Ten Years and Counting on 401(k) Plan Fee Lawsuit

“It ain’t over til it’s over” is a classic Yogi-ism that would seem to apply to one of the seminal class action lawsuits regarding investment fees and revenue sharing in a 401(k) plan. It was ten years ago that one of the first ERISA class action lawsuits was brought claiming that an employer did not meet its fiduciary obligations by maintaining retail class mutual funds which charged higher fees rather than moving to identical institutional funds with lower fees (Tibble vs. Edison International). This lawsuit has yo-yed through federal courts, even reaching the U.S. Supreme Court in 2015 with a remand (a judicial “do-over”) to a lower court to reconsider an earlier decision in favor of the company. Here’s a very brief summary of this still ongoing important federal lawsuit that actually has led to changes in the investment line-up of most companies’ 401(k) plans.

Edison International offered dozens of investment options within its 401(k) plan. But the focus of the initial lawsuit was 17 retail-class mutual funds selected by the plan’s fiduciaries in 1999. These funds charged higher fees than identical institutional funds which became available after 2001. However, the retail funds paid revenue sharing which were used to offset the cost of certain plan expenses paid by the company. In August 2007, a number of plan participants brought a class action lawsuit claiming that those responsible for selecting the plan’s investment choices violated their fiduciary duties of prudence by keeping in place the higher-cost retail funds rather than moving to lower-cost institutional funds.

In 2009, a lower federal court agreed with the company as to its claims and also concluded that any decision as to investment choices made more than six years prior to the filing of the lawsuit could not be considered due to the six-year statute of limitations. In fact, the plan fiduciaries did move into institutional class funds in 2011. So the question of how far back the plaintiffs could seek damages became critical in determining the dollar outcome of this lawsuit.

Following a trial, a federal court concluded that the company acted prudently in selecting the funds, despite the higher cost to plan participants. This decision was upheld by an appellate court. However, in 2015, the U.S. Supreme Court unanimously overturned the lower court’s decisions and indicated that a plan fiduciary has a continuing duty to monitor the prudence of investment choices. The case was then sent back to the lower courts to apply this new standard.

Retail class mutual funds and revenue sharing were fairly common through the 1990s. In fact, it wasn’t until the beginning of the following decade that institutional class funds with lower fees became available as an alternative. There is also been a much greater focus over the past decade in fiduciary duties and obligations. Still, many were surprised by the recently announced decision in this case in which the federal court re-hearing the case determined that plan fiduciaries breached their fiduciary obligation by remaining in the retail-class funds. Taking into account the six-year statute of limitations, this meant that the plan fiduciaries breached their obligations as of 2001, which impacted the amount of penalties and damages. It awarded $7.5 million to the class that sued, plus indicated it would consider also awarding their attorneys’ fees (millions of dollars – after all, this lawsuit has been 10 years and counting).

The court concluded that the plaintiffs were entitled to recovery of excess fees paid from 2001 (the earliest that ERISA six-year statute of limitations would reach) until 2011. These were calculated based on the profits the plan would have accrued had it invested in institutional rather than retail share classes. As far as from 2011 to the present time, each of the parties proposed a different method of calculating damages. In the end, the court did not follow the only other excess fees case that has gone to judgement (Tuessy vs. ABB Inc.) which used the S&P 500 Index Fund as a basis to determine damages. Rather, the court concluded that the best way to determine any lost investment opportunity would be the plan returns as a whole.

This case will likely have historic significance, including its more than ten years in the making – and it’s not over yet either. Over the past decade, there have been more than 75 federal lawsuits alleging excessive fees paid by plan participants. A majority of these are likely to be settled or dismissed. However, the Tibble case will give hope to those that might be able to prove a breach of fiduciary duties.

For nearly a decade, fees within 401(k) plans have been falling. According to a recent survey from NEPC, one of the largest independent full-service investment consulting firms to defined contribution plans, the current weighted average expense ratio is 0.41%. They also reported that the median per-participant fee to administer 401(k) plans rose slightly to $59 in 2017. In their initial survey conducted in 2006, the median fees were $118, twice the current fees. Revenue sharing remains somewhat common to offset fees, but many plans are looking for other ways to give excess revenue back to participants.
You May Have to Review Your Employee Wellness Program

Nearly 90% of companies have some form of employee wellness program, according to various studies. These include everything from health screenings to gym memberships to smoking cessation programs to mental health and stress management programs. All are designed to improve the health and manage stress for employees. Data collected suggests that they can do so. A 2017 Survey of Workforce Health Priorities by Virgin Pulse indicates that effective wellness programs are critical in the recruitment, retention, and engagement of employees.

Does your company offer wellness incentives or penalize employees who fail to enter a smoking cessation program? Any incentives or penalties likely are in line with regulations issued by the Equal Employment Opportunity Commission (EEOC) which permits employers to offer employees an incentive of up to 30% of the cost of the individual’s health insurance plan if they participate in such wellness programs. Late last month, a federal judge issued an opinion that the EEOC must revisit its regulations because the agency did not provide sufficient supporting information for the rules it established (AARP vs. EEOC).

The District Court for DC concluded that the EEOC had failed to offer a reasoned explanation or any concrete data or studies which supported its 30% threshold. The AARP had sued arguing that these regulations would allow companies to penalize employees who opt out of participating in a wellness program. An example could be someone who did not wish to disclose personal medical information. In order to avoid immediate disruption of wellness incentives, especially for 2018 open enrollment, the judge did not require the EEOC to immediately void its regulations. It is somewhat unclear what action the EEOC will now take. This muddies the water for any corporate wellness incentives. So, we are in a “wait and see” situation here.

In another recent lawsuit involving a wellness program, the Department of Labor (DOL) sued Macy’s Inc. and the third-party administrator of their health plan. The lawsuit claims that the Macy’s plan fails to meet the non-discrimination requirements of the Affordable Care Act (ACA) for wellness plans. This is due to not offering a reasonable alternative for individuals to avoid paying a tobacco surcharge, including through participation in a tobacco cessation program. Under the complaint, the Macy’s plan did not offer a reasonable alternative for smokers who could not complete the tobacco cessation program due to a medical condition. The only way to prevent the tobacco surcharge was to be tobacco-free for six consecutive months during the plan year. The DOL claimed that requiring those who smoked to pay a premium greater than that for similarly situated medical plan participants also violated HIPAA non-discrimination rules.

Tobacco surcharges were used by the company to pay claims and administrative expenses. This violated ERISA’s fiduciary and prohibited transaction requirements, according to the DOL complaint. They have sought to have the company reimburse all who paid a tobacco surcharge and to change the terms of its wellness plan.

Tax Court Expands When Employee Meals Can Be Excludible From Income

It’s not very often that we get to highlight the Internal Revenue Code (IRC) in a controversy involving a professional sports team. But the Tax Court recently issued what many consider a surprising decision involving the Boston Bruins hockey team and whether meals provided to employees prior to away games should be both excludible from team members’ income and fully deductible by the employer (Jacobs vs. Comm’r of Internal Revenue).

This case arose after the IRS claimed that the hockey team owners could only deduct 50% of the meal costs provided to the hockey team and staff while on the road for away games. Under IRC §274(n), meals provided to executives or other employees traveling for business are generally only deductible to the extent of 50% of the cost. However, if the cost of the meal qualifies as a de minimis fringe benefit under IRC §132(e), an employer may be able to deduct the full cost and employees would not be taxable on the value. IRC §119(a) allows an employee to exclude the value of any meals furnished by or on behalf of an employer if the meals are furnished on the employer’s business premises for the convenience of the employer. In addition, under Treas. Reg. 1.132-7, an employer-operated eating facility may qualify as a de minimis fringe benefit if, on an annual basis, the revenue from the facility is at least as much as the direct operating cost. That is, an employer may subsidize the cost of food provided to employees provided that the facility covers its own direct costs on an annual basis or meets certain other requirements, including being operated by the employer or located on or near the business premises of the employer providing meals immediately before, during or after an employee’s workday. In addition, the facility must be available on substantially the same terms for all
members of a group of employees defined under a reasonable classification which does not discriminate in favor of highly compensated employees.

In the case at issue, the Bruins hockey team, as well as coaches and staff, were provided group meals at all away games in hotels where the team stayed. Attendance at breakfast and lunch was mandatory for all players, as meetings were held with coaches to discuss game strategy and a number of other issues. While the IRS argued that the rooms provided for this purpose were not employer-operated eating facilities, the Tax Court concluded that they did constitute a business premises of the employer since the team conducted substantial business activities when the meals were furnished. In addition, the team was required to travel for away games under the league contract and therefore, this was a normal course of business.

Having determined that the hotel constituted an employer-operated eating facility, the court then had to address whether it qualified as a de minimis fringe benefit. Here, the court agreed with the Bruins that the meals were provided to all who traveled for substantial non-compensatory business reasons. These included ensuring that the hockey players nutritional needs were met, ensuring consistency of meals to avoid gastric issues during the game, and the limited time for meals in preparation for playing each game away from home.

Although this decision may have been based on the specifics of professional athletes, it may be of interest to corporate employers which provide free or discounted meals to employees in various settings. This decision expands the IRS position that any exclusion from income applies only to remote worksites. It may be that an employer could argue that they are providing meals or even snacks out of concern for the performance and health of their employees, providing a well-balanced nutritionally appropriate meal can benefit both the employees and the company.

It remains to be seen whether the IRS will appeal this decision. However, we thought we would provide you the details whether you are a hockey fan or not.

Did You Know...?

- Forty-four states levy a corporate income tax (the highest rate is 12% in Iowa); four states impose gross receipts taxes (NV, OH, TX, WA) and only two states (SD and WY) have neither, according to data supplied by The Tax Foundation. Oregon has a bicycle tax - but only on the purchase of bicycles with a retail price of $200 or more and a wheel diameter of 26". So does the city of Colorado Springs, CO. Colorado now also has a 15% excise tax on recreational marijuana sales. The states with the highest beer taxes are TN, AK, AL and GA.

- The SEC amended its rules to shorten the time within which broker-dealers must settle securities transactions (i.e., sale of stock) from three business days (T+3) to two business days (T+2) effective as of September 5, 2017.

- According to the Pew Research Center, 37% of adults under age 30 currently have student loan debt. This percentage rises to over 50% for those with a bachelor’s degree or more in education. The median reported loan debt amount as of 2016 was $17,000.

- The Dept. of Labor has now officially released its proposal to extend the transition period for the full implementation of the Best Interest Contract Exemption to its amended fiduciary rules until July 2019. Further amendments to its proposed rules remain possible.
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