Key Income Tax Issues Triggered By Remote Employees

By **Thomas Cryan and Spencer Walters** (November 1, 2022)

Thomas Cryan

Spencer Walters

As a result of the COVID-19 pandemic, the number of employees working remotely has exploded. Employers have discovered the numerous benefits of permitting remote work arrangements, including an expanded talent pool, improvements in employee retention and morale, and the potential to reduce office and relocation expenses.

However, these arrangements can also trigger a variety of employment and corporate income tax issues. The Internal Revenue Service and state tax authorities may have been less likely to rigorously enforce these matters during the height of the COVID-19 pandemic, but enforcement efforts may pick up with increased IRS funding, the expiration of pandemic-related federal funding for state and local governments, and employers' return-to-office efforts. This article outlines some key remote work issues of which corporate tax departments should be cognizant.

Employer Reimbursement of Home Office Expenses

To enable remote employees to work efficiently and securely at their home offices, many employers provide employees with computers, monitors, printers and other office supplies. Employer-provided home office equipment may be excludable as a working-condition fringe benefit under Internal Revenue Code section 132(d).[1]

Under this section, working condition fringe generally is defined as any property or service provided by an employer that, if paid by the employee, would be deductible as a trade or business expense under Section 162.[2]

The value of a working-condition fringe benefit is excludable from an employee's income. To qualify as a working-condition fringe, the benefit received by the employee must be related to the employee's duties for the employer.

The use of employer-provided computers, monitors, printers, desks, chairs and other office supplies should, in most instances, qualify as a working-condition fringe benefit for an employee working from home. However, it is important to remember that employees need to provide their employer with receipts to the extent that the employee purchases and seeks cash reimbursement for these items.

One of the thorniest issues is whether the working-condition fringe exclusion should apply to an employer's reimbursement for home internet expenses. For years, the IRS routinely audited the tax treatment of employer-provided cellphones because employees did not comply with the stringent record-keeping requirements applicable to cellphones as so-called listed property.

The IRS conceded this issue in Notice 2011-72, which states that the IRS will treat the employee's use of an employer-provided cellphone related to the employer's trade or business as a working-condition fringe benefit, and treat any personal use as an excludable de minimus fringe benefit, provided the cellphone is used primarily for noncompensatory business reasons.

The Tax Cuts and Jobs Act of 2017 excluded computers and peripherals — e.g., printers, monitors, fax machines — from the definition of listed property.[3]

However, it is unclear whether this exclusion might apply to home internet, or if Notice 2011-72 should be interpreted to include home internet. Therefore, it is uncertain whether employer-paid internet should be treated as a taxable perk, or if employees must maintain stringent records tracking business and personal use of the home internet, excluding only the portion of employer-paid home internet service used for business.

In light of these uncertainties, tax departments may want to collect some type of substantiation from employees regarding their business versus personal use of home internet and limit the reimbursement to the allocable business use.

Tax Treatment of Travel Benefits for Remote Workers

Employers often pay for workers who live a considerable distance from the primary office to travel to that location for meetings and trainings. However, reimbursements for travel expenses related to an apparent business trip may be taxable, particularly when remote workers are involved.

The primary driver of the tax treatment of daily transportation and overnight travel expenses is the location of an employee's tax home.

An employee cannot deduct — and their employer, thus, cannot treat as a nontaxable fringe benefit — transportation expenses the employee incurred traveling to their place of business merely because the taxpayer made the personal decision to live a considerable distance from that business location.[4]

To be excludable, a reimbursement for overnight travel expenses must be for travel away from home. An employee's home for this purpose is typically the employee's principal place of business.

An employee's principal place of business — i.e., their tax home — primarily affects the tax treatment of lodging and meal benefits provided by the employer.

An employer may only exclude the lodging and meal benefits provided while the employee is traveling away from home from the employee's income. Lodging and meal benefits provided by the employer to the employee in the vicinity of their tax home are generally taxable.[5]

A business trip's origin or terminus may also affect the taxability of the trip's reimbursement. If the employee elects to start or end an overnight trip from a location other than their tax home, the IRS will likely assert that the additional transportation costs incurred by the employer as a result of that personal choice — e.g., for more expensive plane tickets — would result in income to the employee.[6]

Whether a remote employee's tax home is the employee's residence is extremely factual. For the employee's residence to be considered their tax home, the decision to work remotely should be for the employer's convenience, rather than the employee's.

In other words, there must be a bona fide business reason for the remote work arrangement, in order for the reimbursement of travel expenses between the employee's

residence and work location to be excludable.

State Income Tax Withholding Implications

As a general rule, unless a state has a reciprocity agreement with a neighboring state, most states require employers to withhold income taxes based on where the work is physically performed. For example, if a resident of Nevada works in California for a California employer, the employer must withhold California income taxes from the employee's wages.

Complicating the issue, most states also require employers with operations within their state to withhold state income taxes from the wages of residents for services in other states if that state has no income tax — or a lower income tax withholding rate.

Complying with these state income taxes has long been a daunting task for employers, particularly those with a mobile workforce.

Remote work arrangements can trigger employer state income tax withholding obligations in multiple jurisdictions, including jurisdictions where the employer has no offices or business presence.

Some states have a de minimus rule, so that an employee must work a minimum number of days in the state to trigger state income tax withholding — e.g., New York has a 14-day rule for purposes of withholding for nonresident services within New York.

However, many states do not have such a threshold and, for those that do, the threshold may be so low that remote workers — even those working only seasonally — would easily exceed it. Many state tax agencies expect that employers — particularly large employers — will have tools to track an employee's physical work location.

Further complicating state income tax matters, some states — such as New York — have a "convenience of the employer" rule, which imposes income tax liability on nonresident workers who are not physically present in the state, such as remote workers.

Under this rule, if the employee's principal office is located in New York, New York concludes that compensation earned while working at home in another state will be treated as if earned in New York if the employee is working from home for the employee's own convenience and not the employer's necessity.

State Nexus and Permanent Establishment Concerns

Employers may also expose themselves to corporate income tax consequences if they have remote workers, particularly in locations where the employers may not otherwise be conducting business activities.

With respect to state corporate income taxes, states are limited by the U.S. Constitution in their ability to tax activities that do not have sufficient connection to the state.

In its 1977 Complete Auto Transit Inc. v. Brady decision, the U.S. Supreme Court set out a four-prong test that a state tax must satisfy under the commerce clause, including the nexus test.

Under the nexus test, a state violates the commerce clause if there is insufficient strength and degree of connection between the taxpayer's business activity and the state imposing

the tax.

Despite the nexus test being a matter of federal law, states have different interpretations of what constitutes a sufficient state nexus for purposes of imposing a corporate income tax.

In Telebright Corporation v. New Jersey Division of Taxation, decided in 2012, an employee for Telebright moved to New Jersey and worked remotely for Telebright after relocating.

She developed and wrote software code from a laptop in New Jersey, which was then used to create products provided to the company's customers. She was supervised by and reported to a project manager in Boston, with whom she communicated by email and phone. Telebright had no actual office locations in New Jersey.

The Superior Court of New Jersey Appellate Division affirmed the New Jersey Tax Court's opinion that a "foreign corporation that regularly and consistently permits one of its employees to telecommute full-time from her New Jersey residence is doing business in New Jersey [and] is subject to the New Jersey Corporation Business Tax Act."

Many states have a subjective de minimus test to determine whether a corporation's activity within a state is sufficient to create nexus. As a general matter, the likelihood of a state taxing authority finding nexus increases with the number of remote workers performing services within the state.

Employees who work for non-U.S. employers raise similar issues with respect to U.S. federal income taxation of their employers when working remotely in the U.S. The federal rules on the nature and degree of activity necessary to create a permanent establishment for international corporations are facts-and-circumstances dependent.[7]

The creation of a permanent establishment may carry certain U.S. federal tax consequences. The risk that the IRS asserts that remote workers trigger a permanent establishment increases based on the number of workers, the types of activity those workers are performing, the length of the services and whether the employees are employed by a US or foreign entity.

Non-U.S. corporations, or the U.S. operations of those corporations with non-U.S. affiliates, should carefully consider how best to track the number of remote workers in the U.S. and the scope of their activities.

Conclusion

To remain competitive in today's evolving labor environment, many employers will decide to adopt a remote work structure for some or all of their workforce. Understanding the federal and state tax compliance issues that these arrangements can create will allow tax departments to avoid unexpected tax bills from the IRS or state revenue agencies.

Thomas Cryan Jr. and Spencer Walters are partners at Ivins Phillips & Barker.

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[1] Internal Revenue Code Section 132(d).

[2] Internal Revenue Code Section 162.

[3] Tax Cuts and Jobs Act of 2017, 115 P.L. 97.

[4] See Treas. Reg. §§ 1.162-2(e) and 1.262-1(b)(5).

[5] See generally Paolini v. Commissioner, T.C. Memo. 1982-69 (noting that the purpose of the "away from home" provision is to mitigate duplicative expenses for an individual traveling on business away from the location where "it is reasonable to expect the taxpayer to maintain a residence ...").

[6] See, e.g., Treas. Reg. § 1.61-21(g)(4).

[7] See Internal Revenue Code Section 521.104(b)(1).