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Pitfalls and Pathways for a Remote Workforce: What Tax Departments Should Know

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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. IRS 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 COVID-19 related federal funding for state and local governments, and employers' return-to-office efforts. This alert outlines some of the key remote work issues of which corporate tax departments should be cognizant.

1. 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 Code section 132(d). 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 Code section 162. 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 cell phones because employees did not comply with the stringent recordkeeping requirements applicable to cell phones as "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 cell phone related to the employer's trade or business as a working condition fringe benefit and treat any personal use as an excludable de minimis fringe benefit, provided the cell phone usage is provided primarily for noncompensatory business reasons.

The Tax Cuts and Jobs Act of 2017 (TCJA) excluded computers and peripherals (e.g., printers, monitors, fax machines) from the definition of listed property. 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 to limit the reimbursement to the allocable business use.

2. Tax Treatment of Travel Benefits for Remote Workers

Employers often pay for workers who live a considerable distance from the primary office location 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 non-taxable fringe benefit) the employee's transportation expenses incurred traveling to his or her place of business merely because the taxpayer made the personal decision to live a considerable distance from that business location. See Treas. Reg. §§ 1.162-2(e) and 1.262-1(b)(5). To be excludable, a reimbursement for overnight travel expenses must be "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 impacts 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 his or her tax home are generally taxable. *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 . . .").

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 his or her tax home, the IRS would 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. *See, e.g.*, Treas. Reg. § 1.61-21(g)(4).

Whether a remote employee's "tax home" is his or her residence is extremely factual. The decision to work remotely should be for the employer's convenience, rather than the employee's, for the employee's residence to be considered his or her tax home. 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.

3. 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 minimis 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.

4. 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 *Complete Auto Transit, Inc. v. Brady*, the Supreme Court set out a four-prong test 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 not sufficient nexus between the activity and the state imposing the tax. A nexus is the strength and degree of connection the taxpayer's business activities have to the state.

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. Director, New Jersey Division of Taxation*, decided in 2012, an employee for Telebright Corporation 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 court 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."

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Many states have a subjective "de minimis 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 United States. The Federal rules on the nature and degree of activity necessary to create a permanent establishment for international corporations are facts-and-circumstances dependent. See Code section 521.104(b)(1). 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.

5. 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 workforces. 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.

Because remote work arrangements raise many issues and each one can be complicated, not only do Tax and HR departments need to coordinate carefully, but it also may be helpful to seek outside counsel review and support.

For questions related to this alert, please contact Tom Cryan or another member of our Tax or Benefits & Compensation team.

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