Courtesy withholding

Resident income tax withholding considerations and guidelines

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Courtesy withholding: resident income tax withholding considerations and guidelines

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Income tax withholding is a key obligation that comes with having employees, but when it comes to the state and local jurisdictions where employees reside, it's not always a requirement that taxing authorities can impose on employers. Nonetheless, even when not required to, many employers withhold resident income tax as a courtesy to their employees.

Here we will explain the general guidelines for determining if resident income tax withholding is required and the risks and benefits of courtesy withholding.

Do I have to withhold resident income tax?

With some exceptions as stipulated under federal and local law, an employer is required to withhold income tax in the jurisdiction where employees work. When the employee's work and resident state are the same, this requirement is straightforward. But if the employee lives in one state but works in another, the employer's income tax withholding obligations are more complex. For example, if an employee resides in New Mexico but works in Utah, can New Mexico impose an income tax withholding requirement? The answer to this question hinges largely on nexus.

Resident income tax withholding can be imposed only if the state can assert nexus, or put another way, the state can demonstrate that the employer's activity within the state is sufficient to establish a business connection.

In the *Quill* (1992) case,[1] the US Supreme Court made clear that there are two nexus requirements, one under the due process clause (minimum contacts) and the other under the commerce clause (substantial nexus). They are different, but both must be satisfied.

Two requirements for nexus

Commerce clause

- Objective of the clause is to encourage interstate commerce and to be sure that states don't impose impediments to its development.
- At least for sales tax purposes, we know that "substantial nexus" requires some kind of physical presence in the state for tax to be imposed.

Due process clause

- Was it "fair" to impose the tax on the taxpayer?
- Should the taxpayer have anticipated that its activities were sufficient in the jurisdiction to subject it to tax?

[1] Preceding *Quill* was *Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 51 L. Ed. 2d 326, 97 S. Ct. 1076 (1977)* and its four-prong test. The "tax 1. is applied to an activity with a substantial nexus with the taxing State, 2. is fairly apportioned, 3. does not discriminate against interstate commerce, and 4. is fairly related to the services provided by the State." (cited in *Quill* at 504 U.S. at 311).

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While state and local laws vary in their application of nexus, what is clear is that an employee's mere residence in a state is likely insufficient to establish a requirement that the employer withhold resident income tax from those wages. On the other hand, if that employee performs services within the resident state, including substantial work from the home office, or other employees work within the state, income tax withholding is required of all residents in the state.

Events that can trigger a resident income tax withholding requirement

Any or all of these activities can trigger a resident income tax withholding requirement for all employees residing in the state:

- Opening a business office in the state
- Assigning resident employees to work in the state
- Assigning nonresident employees to work in the state
- Allowing employees to regularly work from home in the state
- Implementing a reciprocal income tax agreement involving employees who reside in the state

Example 1 — no business activity in resident state

ZapCo maintains a business office in Utah, and its employees provide no services outside of the state. Employee Joe is a resident of New Mexico who travels to the Utah office each day for work. Joe does not work from his home office in New Mexico.

Result. Because ZapCo has no business activity within New Mexico, it is not required to withhold New Mexico resident income tax from Joe's wages. However, Joe is working in Utah, and ZapCo must withhold Utah nonresident income tax from his wages.

Example 2 — home office in the resident state

Assume the same facts as Example 1 except that employee Mary is hired to work full-time from her home office in New Mexico.

Result. The home office work constitutes business activity within New Mexico; therefore, New Mexico resident income tax withholding applies to wages paid to all New Mexico residents working for ZapCo, including Mary and Joe. Joe is entitled to a credit against his New Mexico income tax for nonresident income tax paid to Utah when he files his New Mexico personal income tax return. (New Mexico personal income tax forms.)

Example 3 — nonresident business activity in the resident state

Assume the same facts as Example 1 except that ZapCo's system programmer, Julie, travels from Utah to New Mexico to assist a client for one month in the development of a security system.

Result. Julie's nonresident assignment constitutes business activity within New Mexico; therefore, New Mexico nonresident income tax withholding applies to wages paid to Julie for her programming services within the state (and Utah resident income tax withholding on all wages she is paid, less a credit for New Mexico nonresident income tax withheld). (*Utah Pub. 14, Employer Tax Guide, pg. 2.*)

Accordingly, ZapCo must withhold New Mexico income from all employees who reside in the state, including Joe. Joe is entitled to a credit against his New Mexico income tax for nonresident income tax paid to Utah when he files his New Mexico personal income tax return.

As these examples illustrate, an employer's resident income tax withholding obligations can change over time depending on business activity within the state(s). Consequently, when a business decides it will not withhold resident income tax, it must carefully monitor employer and employee activity within the state to confirm that changing circumstances have not triggered a resident income tax withholding requirement.

Reciprocal income tax agreement considerations

If states have entered into a reciprocal income tax agreement, the nonresident state forgoes its income tax withholding requirements provided that income tax on those wages is withheld in the employee's resident state. (Note that in most cases, the nonresident state requires that employees complete a certificate of residency or other form to qualify for this exemption.)

Since the waiver of nonresident income tax withholding is contingent on resident income tax withholding, the employer must be registered for income tax withholding with the resident state, even if there is an absence of nexus.

Example:

Margo, who is a resident of Pennsylvania, provides services in New Jersey for her New Jersey employer. Margo's employer has no business activity in Pennsylvania and is not registered for Pennsylvania income tax withholding. Margo requests that her employer withhold only Pennsylvania resident income tax under the reciprocal agreement with New Jersey. (*Pennsylvania reciprocal agreements.*)

Result: Having nexus in Pennsylvania is irrelevant in this case. Margo's employer must withhold New Jersey nonresident income tax until such time as it opts to register with Pennsylvania for income tax withholding.

States with reciprocal agreements	
District of Columbia[2]	Montana
Illinois	New Jersey
Indiana	North Dakota
Iowa	Ohio
Kentucky	Pennsylvania
Maryland	Virginia
Michigan	West Virginia
Minnesota	Wisconsin

[2] The District of Columbia does not require income tax withholding on the withholding of nonresidents.

Courtesy withholding — general requirements

As a courtesy to employees, many employers withhold resident income tax even when they aren't required to, a benefit that helps employees avoid unexpected tax obligations when they file their state personal income tax returns.

Beyond employee morale, courtesy withholding is also preferred by employers with significant cross-state business activity that might easily trigger an unexpected mandate to withhold resident income tax.

An important point to keep in mind about courtesy withholding is that once income tax withholding begins, the business is subject to the state's income tax withholding payment and reporting rules. The employer can be held liable for resident income tax it fails to correctly withhold; withholding tax payments not timely made; and it can be assessed penalties for failure to file correct and timely returns and information statements. For instance, when an employer courtesy withholds for a state, it is required to issue Forms W-2 to employees showing in box 16 the total taxable wages paid the resident employee and any resident income tax withheld.

2016 Multistate Payroll Tax Compliance Survey

Courtesy withholding

Do you provide state courtesy withholding for your employees?

Yes	45%
No	34%
For some	21%

Overall results were generally matched by employers large and small in all industries.

The Multistate Payroll Tax Compliance Survey is hosted by Ernst & Young LLP and Bloomberg BNA and is conducted annually. To access all of the 2016 survey results, click here.

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2017 webcast polling results

Courtesy withholding: incorrect tax assessments

As an employer that provides voluntary income tax withholding, have taxing authorities incorrectly assessed other business taxes such as unemployment insurance or corporate income tax?

1,224 respondents

Yes **36%**

No **28%**

Will check on this **36%**

This polling question was asked of participants of the June 21, 2017, Ernst & Young LLP webcast, "US multistate payroll tax: getting to the source." Watch a replay of the webcast here.

Courtesy withholding — the risk of improper business tax assessments

Other taxes may be imposed on employers doing business in the state, for instance, unemployment insurance, corporate/franchise income or sales and use taxes. Consequently, employers that courtesy withhold must be mindful of their potential exposure to incorrect assessments for other businesses taxes in the state.

According to polling results from our June 21, 2017, webcast, 36% of courtesy withholders reported having been incorrectly assessed business taxes, and another 36% plan to review their tax accounts for this error.

Taxing authorities frequently use employer income tax withholding accounts as a starting point for determining if there are other taxes the business is required to pay. In this process, the state may overlook the fact that the business is merely courtesy withholding and is not subject to the state's taxes. If tax accounts are not regularly monitored, faulty business tax assessments can be issued, increase over time from added interest and penalty, and sometimes, result in liens or similar business interruptions.

Watch out for unemployment insurance overpayments

Incorrect payment of unemployment insurance is one of the most common occurrences for courtesy withholders.

Sourcing for unemployment insurance is governed by the federal law and follows a four-prong test. (U.S. Department of Labor, Program Letter 20-04.) In simple terms, unemployment insurance is paid to the state where the employee works.

Considering that courtesy withholding applies to employees who work outside of their resident state, unemployment insurance should generally not be paid to the state where courtesy withholding applies.

Unemployment insurance overpayments can occur when courtesy withholders pay unemployment insurance in both the resident state and the employee's work state. Overpayments can also occur because the employer incorrectly paid unemployment insurance to a resident state that has a higher wage base or unemployment insurance tax rate than the employee's work state.

Businesses that provide courtesy withholding should carefully confirm that they are paying unemployment insurance correctly and apply for refunds of overpayments that may be discovered.

Creating a courtesy withholding checklist

If not properly managed, courtesy withholding can expose employers to erroneous assessments for other business taxes and can contribute to the overpayment of unemployment insurance taxes. In addition, if the business has determined it will not voluntarily withhold resident income tax, it must perpetually monitor its activities to identify if changing circumstances have triggered an income tax withholding obligation. For these reasons, employers should consider incorporating the steps shown below in their multistate payroll tax compliance processes.

Courtesy withholding checklist

- ✓ Consult your tax advisor when registering a new income tax withholding account to ascertain the extent that other businesses taxes may apply
- ✓ If courtesy withholding is the only connection with the state and there is no place on the business registration form to communicate this fact, call or write the taxing authority bringing to their attention that nexus does not apply
- ✓ Monitor courtesy withholding accounts closely for incorrect business tax assessments and respond promptly to any agency notices
- ✓ Confirm that you are paying unemployment insurance to the correct states and make a prompt claim for refund where overpayments are discovered
- ✓ If you are not withholding resident income tax in some states due to a lack of nexus, review employee work locations, telecommuter assignments and other business activity within the state(s) at least quarterly to confirm that a lack of nexus continues to apply

For more information on multistate state income tax withholding compliance:

- Watch a replay of our June 21, 2017, webcast here.
- Download the June 21, 2017, webcast slides here.
- Download our special report here.
- Download the results of the 2016 Multistate Payroll Tax Compliance survey here.
- Check out all of our other resources at our website, Get on board.

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