. . . as appeared in . . .

Practical US/Domestic
Tax Strategies

WorldTrade Executive, Inc.
The International
Business Information
Source™

How US Business Manages Its Tax Liability

June 2006
Volume 6, Number 6

Do You Know Where Your Employees Are? New York State Thinks You Should!

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More than a year has passed since the New York State Department of Taxation and Finance (Department) released the final version of its Withholding Tax Field Audit Guidelines (Guidelines) on April 5, 2005. Since that time, the Department's Audit Division has refocused its efforts on withholding tax examinations. We have seen a significant increase in audit activity for New York employers.

New York's unique role as the center of commerce creates the backdrop for the recent focus on state personal income tax withholding. Senior executives, directors, consultants, and salespersons frequently visit New York for a myriad of reasons such as meetings with investment bankers, attending board meetings, calling on customers, or attending trade shows. The vast majority of these visits go undetected by the Department because employers generally do not track where their employees perform services. Employers often do not withhold in states other than the employee's primary work state or state of residence.

The reality is that if an employer does not withhold on wages earned for services performed in New York and does not issue the employee a W-2 indicating New York wages, it is unlikely that an employee will file a New York nonresident return. The Department is aware of, and is attempting to change, this reality.

The Department's Guidelines provide a vehicle to increase compliance at the source (i.e., the employer) for both the number of employees filing New York income tax returns and the proper amount of withholding on New York source income. Many large employers have responded that it is unreasonable for the Department to expect employers to track the location of their employees on a daily basis.[1] The Department's reply is that tracking can be easily accomplished through the use of a simple one-page form, Form IT-2104.1.[2]

Form IT-2104.1 is used by a New York nonresident employee to inform an employer the percentage of services[3] that will be performed by the employee in New York State during the year. The employer should withhold on that employee's wages for New York purposes based on the percentage indicated on the form.[4] According to the Department, an employer who dutifully collects the forms from its New York nonresident employees annually and retains the forms from prior years should be able to accurately determine the percentage of services performed in New York and withhold on regular wages as well as various items of deferred compensation.[5] Stated in other terms, the Department's position is "how difficult is it to collect a form from each employee once a year?"

While some employers are still resisting, many have put policies and procedures in place to educate their employees on multistate withholding obligations, collection and retention of Form IT-2104.1, and to integrate the appropriate information into human resource and payroll systems.

What if an employer does not collect the form from its employees? How will the Department ever know if an employee performed services in New York? The Department has indirectly answered this question in the Guidelines. The Guidelines outline a procedure for requesting and reviewing travel and expense documentation such as travel vouchers, calendars, corporate credit card statements, etc., where an auditor believes highly-paid employees are performing services

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in New York. Given that employers typically retain expense reimbursement documentation, the paper trail leading to New York services can often be found down the hall from the employer's Tax department in the Accounts Payable department.

A non-compliant employer must pay the underwithheld tax with interest on the amount underwithheld and may be subject to a range of penalties.[6] Regarding penalties, the Department's Guidelines instruct auditors to take into consideration that employers need a transitional period to put the necessary procedures in place in order to comply with the Guidelines. "For example, if a company is making reasonable efforts to comply with nonresident withholding requirements, including but not limited to implementing and perfecting new systems for nonresident withholding, the auditor may decide not to impose penalties on nonresident issues if there are no other facts present which would warrant imposition of penalties."[7] However, the applicable transitional period was the 2005 payroll cycle. For payroll cycles after 2005, it seems unlikely the Department will be lenient in applying penalties considering that employers were put on notice by the issuance of the Guidelines in 2005.

The Guidelines put employers on notice that New York's employer withholding rules should now be a priiority.

New York's focus on nonresident withholding has raised issues beyond employer withholding, including franchise tax nexus from non-resident employees, over-reliance on the 14-day *de minimis* rule, taxation of employees on international assignments, and calculating New York source income from deferred compensation.

New York State Corporate Franchise Tax Nexus

The issue of nexus typically arises when a New York employer, while attempting to comply with the Guidelines, discovers that employees of a related entity not filing in New York are performing services in New York. A decision may have been made in the past that the New York activities of the related entity's employees were not sufficient to establish the requisite nexus to require filing for New York corporate franchise tax purposes. Alternatively, nexus with New York may never have been considered or the related entity's business may have recently expanded into New York. The question presented by this situation is whether the entity should file for withholding and other tax purposes in New York.

New York imposes withholding tax obligations on an employer who is "maintaining an office or transacting business" within New York State and paying wages to an employee performing services in New York State.[8] While it is easy to determine if an entity maintains an office, little guidance addresses what is considered "transacting business" within the state.

For corporate franchise tax purposes, any entity doing business, employing capital, owning or leasing property, or maintaining an office is subject to the tax.[9] Arguably, the withholding tax nexus standard is broader than the corporate franchise nexus tax standard. It is not clear, however, whether the "transacting business" and "doing business" standards should apply in similar fashion. Compounding this dilemma is the likelihood that the Department will inquire why a New York employer is not filing for corporate franchise tax purposes.

If employees of a non-compliant entity are found performing services in New York, the Department has alerted and encouraged its auditors to keep their eyes open for situations where it may be appropriate to request an audit in another tax area "such as sales tax or corporation tax" as well as personal income tax.[10] One section in the Guidelines addresses "Offshoot cases." An auditor who stumbles upon a non-filing New York employer will likely issue a nexus questionnaire shortly thereafter.

High-Wage Earners and the 14-Day Rule

The one aspect of the Guidelines that received the most attention was the creation of a clear *de minimis* threshold for withholding, commonly referred to as the "14-day rule."[11] The Guidelines state that an employer is not required to withhold for any employee, not assigned to a primary work location in New York, who performs services in New York for 14 or fewer days in a calendar year.[12] There appears to be a great misconception with respect to the application of 14-day rule. Technically, the 14-day rule applies only to an employer's withholding obligation, not to an individual's personal income tax filing responsibility.[13]

> *Example:* Individual A performs services in New York for 10 days during the current year. Under the 14-day rule, Individual A's employer, Corporation X, is not required to withhold on Individual A's wages for New York purposes. However, Individual A is required to file a New York State nonresident return and pay tax on wages earned while performing services in New York.

Moreover, the 14-day rule does not apply to deferred compensation.[14]

> *Example:* Individual A performs services in New York for 10 days during the current year and in each of the prior two years, 2004 and 2005. Individual A received stock option grants in January of 2004 and exercised those options in

2006. Individual A's employer, Corporation X, is not required to withhold on Individual A's 2006 regular wages for New York purposes. However, the Guidelines provide that Corporation X is required to withhold on the income from the stock option exercise that is connected to services performed in New York.[15] Individual A is required to file a New York State nonresident return and pay tax on the stock option income from the exercise in 2006, as well as wages earned while performing services in New York.

If a nonfiling situation is discovered by the Department during a withholding examination, the Department is not likely to commence an individual audit for any moderately paid employee due to the fact that the dollar amount of any potential exposure is probably small. However, high wage earners (particularly those holding the title of CEO, CFO or senior executive) should be aware that the Department devoted a few pages in the Guidelines to examining such employees. Specifically, the Guidelines state if an auditor believes highly-paid employees may be performing services in New York, the auditor should perform a sampling by requesting documentation of the employees' travel activities. Employees selected as part of the sample who have submitted hotel receipts, restaurant receipts, airline vouchers, etc., for expense reimbursement related to trips to New York in excess of 14 days may be selected for a personal income tax audit. Individuals who have had over 14 days of business trips to New York may want to consider entering into a voluntary disclosure agreement with New York.[16]

Employers that fail to upgrade their compliance procedures for withholding should beware.

International Assignments

It is not uncommon for entities based overseas that do not file in New York to send employees (i.e., nonresident aliens) from the home office on a temporary assignment to perform services for a U.S. affiliate in New York. This scenario raises at least two issues.

First, if a nonresident alien employee claims an exemption from U.S. tax based on a federal treaty, the individual is not automatically exempt in similar fashion for New York tax purposes. However, the Guidelines state that if a nonresident alien employee in this situation files a statement with the employer containing identifying information and a reason that the exemption is claimed, the employer may accept the statement and not withhold on the employee.[17]

Second, if a federal treaty exemption does not apply, then the nonresident individual's filing status becomes an issue. An individual who maintains a permanent place of abode in New York and is present in New York for more than 183 days in any calendar year is deemed a statutory resident and taxed on all income, both earned and passive. A nonresident individual on temporary assignment in New York will likely have a New York address on file with the employer as of the start date of the assignment, and will often satisfy the 183 day test if the individual's primary work location is in New York. Therefore, unless an exception applies, the individual will be taxed as a resident of New York.

While New York does have a residency exception for employees on temporary assignment in New York, the Department's application of the exception, which effectively imposes tax on New York source income, has narrowed significantly in recent years. The exception is met where the assignment is for a fixed and limited period, typically no longer than three years, and the assignment is for the accomplishment of a particular purpose. In order to be deemed a particular purpose, the assignment must have readily ascertainable goals. It is the second prong of the test that has come into controversy lately on audit.

Unfortunately, there is not much precedential guidance on this issue and the Department has been consistently challenging claims by taxpayers that the exception applies to their particular situation. When pressed for a clearer standard, Department representatives typically respond with the example "coming to New York to build or paint a bridge" as a situation that the Department would consider to fall within the exception. Accordingly, employers should draft any contracts or letters that outline the terms, goals, and period for an international assignment to New York with care.

It seems surprising that the Department would narrowly construe the temporary assignment exception and deter highly-compensated senior executives from around the globe from coming to New York. For each corporate executive that chooses to decline an assignment in order to protect their non-New York-sourced income from New York personal income tax, New York loses the revenue from avoided property tax, sales tax, and, New York-sourced personal income tax that otherwise would come from international assignees.

Deferred Compensation

For state withholding purposes, rules regarding withholding on deferred compensation are complex and vary from state to state. Deferred compensation is typically defined as "income earned in one year and paid in a later year"[18] and often includes stock option income and bonus payments. Many forms of deferred compensation, such as nonqualified stock options or restricted stock units, can span multiple years. A determination of the proper withholding for New York, as well as other states, generally requires an up-to-date knowledge of the withholding rules as well as procedures for tracking locations where employees perform services over the compensable period of time. Historically, employer payroll departments have not given due care to this issue.

The Department has backed up the Guidelines with an increase in audit activity.

Several employers recently audited by New York now understand the significant exposure in this area. Deferred compensation payments can be in the millions of dollars for senior executives.

The issue of sourcing deferred compensation has been mired by recent New York litigation. In *Matter of Stuckless*, a taxpayer who worked in and out of New York over a period of years successfully challenged the Department's methodology for sourcing income from stock options.[19] The decision called into question the Department's long-standing methodology, as set forth in a 1995 interpretive memorandum,[20] requiring stock option income to be sourced to New York based upon the ratio of New York work days over total work days between the grant and exercise dates. However, New York State's recent budget bill contains a provision requiring the Commissioner to issue regulations regarding the proper computation of a nonresident individual's New York source income from statutory stock options, restricted stock, nonstatutory stock options and stock appreciation rights.

Conclusion

The issuance of the Guidelines was not intended to create new law. The Guidelines put employers on notice that compliance with New York's employer withholding rules, an area not given much attention by the Department in the past, should now be a priority. The Department has backed up the Guidelines with an increase in audit activity. Employers that heed the warning should be rewarded with no-change letters and limited document requests upon audit. Employers that fail to upgrade their compliance procedures for withholding should beware.

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[1] See the *de minimis* discussion on "High-Wage Earners and the 14-Day Rule," *infra*.
[2] Form IT-2104.1, New York State, City of New York, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax.
[3] The percentage of services is typically based upon the number of days worked in New York during the year divided by the employee's total number of work days, wherever performed, during the year. In a typical year the average employee works approximately 240 days when taking into account vacation days, holidays, sick days, etc.
[4] Note, employers cannot blindly rely on a Form IT-2104.1 submitted by an employee. According to the Guidelines, an employer may rely on a Form IT-2104.1 submitted by an employee "as long as the employer does not have actual knowledge or reason to know" that the information contained on the form is incorrect or unreliable. *See* Guidelines, p. 16. In addition, an employer is considered to have "reason to know" that the form is incorrect "if its knowledge of relevant facts or of statements contained in the form is such that a reasonably prudent person in the position of the employer would question the claims made." *Id*. A full discussion of the various policies and procedures that can be put in place in an effort to comply with the rules in the Guidelines is beyond the scope of this article.
[5] See discussion of "Deferred Compensation," *infra*.
[6] Under N.Y.S. Tax Law § 685, failure to file, failure to pay, negligence, and fraud penalties may potentially apply.
[7] Guidelines, p. 16.
[8] N.Y.S. Reg. § 171.1(a).
[9] N.Y.S. Reg. § 1-3.2(a)(1)(i)-(iv).
[10] Guidelines, pp. 55-56.
[11] Guidelines, pp. 25-26.
[12] It should be noted that when counting, "a reasonable number of training days/professional developments days" is not included. *See* Guidelines, p. 26. In addition, any part of a day is deemed a full day for this purpose. *See* Guidelines, p. 25.
[13] Guidelines, p. 25.
[14] *Id.*
[15] See discussion of "Deferred Compensation," *infra*, for more information regarding the proper allocation of income to New York.
[16] In general, the benefits of entering into a voluntary disclosure agreement are abatement of civil and criminal penalties as well as a limited look-back to prior years.
[17] Guidelines, pp. 30-31.
[18] Guidelines, p. 21.
[19] *Matter of Stuckless*, Tax Appeals Tribunal, DTA No. 819319 (May 12, 2005), motion for reargument granted, *Stuckless*, Tax Appeals Tribunal, Order & Opinion, DTA No. 819319 (Dec. 15, 2005).
[20] TSB-M-95(3)I. ❑