Summer 2021

Estate Planning Update Summer 2021 - You Live Where for Income Tax Purposes?

Many taxpayers preparing their state income tax returns for 2020 have an additional layer of complexity to address this year. As a result of the pandemic, relocation and remote working became standard for many office workers, creating new filing and reporting requirements. Since states have a variety of rules for addressing remote working scenarios that often overlap or contradict one another, many taxpayers are understandably confused about where they need to file and where they owe taxes.

"Convenience of the Employer" Rule

Certain states (e.g., Connecticut, New York, Pennsylvania) tax employees based on the location of an employer's office. Under this so-called convenience-of-the-employer rule, an employee is viewed as working in the employer's state if their employment activities outside that state are only for the employee's convenience and not for the employer's necessity. In situations such as a pandemic or lockdown, an employee's working out of state from home is typically not viewed as for the employer's necessity despite an employee not having much choice in the matter. The result may be that employees who never even enter the state where their home office is located will owe taxes to that state. During the pandemic, it became a common occurrence for an employee who previously commuted to a convenience-of-the-employer state to work from home despite the formal office address remaining the same. Massachusetts was so concerned about residents of New Hampshire (a no-income tax state) who were no longer commuting into Massachusetts for work that the Department of Revenue put in place an emergency regulation taxing out-of-state workers who had previously commuted to Massachusetts (making it a de facto convenience-of-the-employer state).

Since the general rule is that you are taxed in the state where your income is earned, remote workers who previously worked in a convenience-of-the-employer state could face double taxation depending on the application of the tax credit mechanism in their resident state. During the early part of the pandemic, many New Jersey residents who commuted to New York for work were encountering this concern while working from home for their New York employer. New Jersey generously declared that residents who normally commute to New York but had to work remotely due to the pandemic would continue to receive a credit to offset taxes collected by New York. Connecticut did the same. Other states, like Massachusetts, (as discussed above) have not been as kind.

Reciprocity

Layered on top of the above rules are reciprocity agreements between states. For example, New Jersey and Pennsylvania have an agreement where compensation paid to residents of one state who are employed in the other state is taxed only by the employee's state of residence. So a New Jersey worker who usually commutes to Pennsylvania but now works from home will continue to be taxed on wages by New Jersey but not by Pennsylvania. However, if that New Jersey resident decided to move during the pandemic and give up their New Jersey residency, the reciprocity agreement would no longer cover the employee's Pennsylvania wages. Moreover, reciprocity may not extend to income or wage taxes imposed by cities.

Filing Requirements

Different states also have different thresholds for when taxes and related tax withholdings are required. For remote workers who have decamped to a new state, taxes and tax withholdings may be triggered on the taxpayer's first day of work in the state. Other states require that a taxpayer spend a certain amount of time in the state, typically more than 14 days, before a filing requirement and/or a tax withholding requirement by the employer kicks in. Despite this, most if not all states do offer a credit for income taxes paid to other states to at least in part mitigate the risk of double taxation.

Domicile

While wages are generally taxed where earned, unearned income (dividends, interest, capital gains) will be taxed by a taxpayer's state of residence. Many states will consider taxpayers to be residents of the state if they are (1) domiciled in the state, or (2) statutory residents of the state.

The domicile test centers on one's state of mind: Where do you consider your home to be? It is typically defined as the place that you intend to return to after an absence. Generally, taxpayers maintain their existing domicile until they have demonstrated that they have abandoned that domicile and established domicile in another state—the concept of "leave and land."

The statutory residency test is more formulaic in its application. If you "maintain a permanent place of abode" in the state and spend more than 183 days in state during the year, you are automatically considered a resident.

Many office workers looking for more space amid the pandemic acquired or leased vacation homes outside their home office state. If a New York domiciliary rented a home in Connecticut at the beginning of the pandemic and stayed for the rest of the year, intending to return home after the pandemic subsided, that taxpayer would maintain his status as a domiciliary of New York, yet also likely be considered a statutory resident of Connecticut. Maintenance of a vacation home outside the state used during the pandemic would not, in itself, be viewed as sufficient to indicate a change of domicile, assuming one intends to return to the state.

Conversely, taxpayers who are recovering in a state from COVID-19-related illness may still be considered residents of the state if they spend more than 183 days in the state, despite only staying in the state to receive outpatient or convalescent treatment.

Conclusion

While the intersection of various state tax laws has always been confusing and in many cases unfair, the COVID-19 pandemic has highlighted the difficulty in taxing remote workers. As many have adjusted to the new normal, this trend will likely continue, resulting in a host of future complex state tax reporting and compliance scenarios. Unfortunately, although federal legislation on these issues has been considered for many years, it is probably not likely that we will see any enacted, at least in the near future, to provide any sort of uniformity and consistency in this area. It is important to get tax advice specific to each individual's situation, taking into account any changes in residence or work location, whether temporary or permanent.