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Telecommuter Tax Fairness Act of 2005: Restoring Balance to State Taxation of Telecommuters

by Chris Atkins

I. Introduction

In 1994, Thomas Huckaby began telecommuting to his office in New York City from his home in Tennessee. Though he would make trips to his employer's office in New York, the vast majority of his work time was spent in Tennessee. Thus, when he filed nonresident tax returns in New York for tax years 1994 and 1995, he apportioned 25 percent of his income to New York.[1]

When his return was audited, New York tax officials claimed that he had to apportion 100 percent of his income to New York, based on their "convenience of the employer" rule on telecommuting.[2] The New York Court of Appeals (the highest court in New York) eventually upheld the state's determination, and the U.S. Supreme Court declined to hear the case.

Mr. Huckaby's dilemma is another example of the friction between the 21st century economy and state tax systems which are largely based on a 20th century economy.[3] While there are legitimate reasons for anti-abuse rules in the case of telecommuting, New York's rule violates many tenets of sound tax policy, including the principle that taxes should be levied in exchange for services received from the government, and will lead to widespread double taxation of telecommuters. The Telecommuter Tax Fairness Act of 2005, a bill originally introduced by Senators Dodd (D-CT) and Lieberman (D-CT) in the Senate (S. 1097) and Representative Christopher Shays (R-CT) in the House (H.R. 2558), seeks to restore the correct balance to state taxation of telecommuters.

II. New York's "Convenience of Employer" Rule

New York law allows taxpayers to apportion their income between New York and other states if they perform services in other states.[4] To secure such treatment, however, New York requires that services performed outside the state be done out of necessity as opposed to convenience.[5] Thus, since telecommuters usually work out of their homes for convenience, New York consistently requires telecommuters located in other states (like Mr. Huckaby) to pay tax on 100 percent of their income in New York.[6]

New York is one of only four states with a “convenience of the employer” rule for telecommuters. The others are Delaware, Nebraska, and Pennsylvania, though it is reported that these states do not enforce their rules as aggressively as New York.[7] With the Supreme Court declining to hear the *Huckaby* case, and no action thus far taken in Congress, states have little to lose politically and much to gain fiscally by moving toward more aggressive enforcement actions against telecommuters.

Of course, states do need to be careful about the tax treatment of telecommuting. Loose rules on telecommuting would invite abuse, as taxpayers who make the normal commute during the week could claim they were telecommuting on the weekend (when if fact they were doing no work) and siphon income away from the state in which they work. There is a way, however, to craft a rule that prevents abuse and state overreaching. New York’s "convenience of the employer rule" acts as a hacksaw when a scalpel is all that is needed.

III. Analysis

The Telecommuter Tax Fairness Act of 2005 would require a nonresident taxpayer to be physically present for work in a state before he is required to pay tax on his income. Thus, a telecommuter could not be forced to pay tax on 100 percent of his income in a state where he physically worked less than 100 percent of his work days.

Due to the importance of state tax sovereignty—which is guaranteed by the 10th Amendment to the Constitution— Congress must be careful anytime that it seeks to preempt state and local tax authority, as the Telecommuter Tax Fairness Act would do. For the reasons outlined below, however, Congress would be well advised to preempt state tax authority in the case of telecommuter tax issues.

The most important reason for Congress to act is to prevent state taxpayers from facing double taxation. Absent federal action, many telecommuters will continue to pay taxes on over 100 percent of their income. Because states do not consistently credit taxes paid to other states, telecommuters in some states will be disadvantaged in the absence of a rule like that contained in the Telecommuter Tax Fairness Act (see example in Table 1). This double taxation introduces economic distortion into the decision whether to telecommute or normally commute.

Table 1: The Telecommuter Tax Fairness Act Reduces Double Taxation for Telecommuters

	Connecticut	New York
Percentage of time spent working in each state	75%	25%
Rules on splitting telecommuter income	Credit for taxes paid in other state based on days worked in other states	Convenience of the employer
Income listed on return	$100,000	$100,000
Tax rate[a]	5 percent	6.85 percent
Tax liability	$5,000	$6,850
Total credit	$1,250 ($25,000 allocation to New York[b] * .05 tax rate)	$0
Total tax paid (under current rules)	$3,750	$6,850
Total tax paid (under S. 1097's physical presence rule)	$3,750	$1,710
Difference in taxes paid between current system and S. 1097	$0	-$5,140

[a] This example assumes that our hypothetical employee would pay tax on all of his income at the top rate levied in Connecticut (5 percent) and New York (6.85 percent).
[b] Connecticut credits taxes paid in other states to the extent that the work is physically performed in that state. In this case, the credit equals the taxpayer's share of income earned in New York (25 percent) times the Connecticut tax rate of 5 percent.

Source: Tax Foundation.

The next most important reason for Congress to act is the benefit principle of taxation, which says that a state should get the right to tax a person's income when that person is benefiting from services provided by the state.[8] A physical-presence rule better matches taxes paid and benefits received, since only employees who are physically present are significantly benefiting from public services.[9]

When Mr. Huckaby telecommutes, he is virtually present in New York, but physically present in Tennessee. Thus, when telecommuting he is primarily benefiting from roads,

schools and prisons in Tennessee, and Tennessee should be able to tax his income based on the benefit principle.

When he goes to New York, however, he primarily benefits from roads, schools and prisons in New York. Thus, when he works in New York, that state should be able to tax his income based on the benefit principle. Since New York claims the right to tax 100 percent of Huckaby's income, however, and shows no sign of changing its policy, only Congress can craft a uniform rule that accurately matches taxes paid with benefits received.

Congress must also act to reduce tax complexity. While telecommuters will usually not have a difficult time allocating their income between the state where they live and the state where their employer is located, telecommuting could become a compliance nightmare for employers.

Businesses with telecommuters in other states would have to withhold income tax for their employees in those states. Since different states have different rules on telecommuting, this would quickly become a compliance burden for businesses. A rule like that embodied in the Telecommuter Tax Fairness Act would create one clear, simple rule to guide businesses who have to withhold for telecommuters in other states.

Another issue involved in the telecommuter tax issue—though not addressed by the Telecommuter Tax Fairness Act—is nexus. According to BNA's *2004 Survey of State Tax Departments*, over 40 states assert the right to tax an employer's income based on the in-state presence of a telecommuting employee (see Table 2). In the 2001 survey, only 32 states asserted the same right. In Thomas Huckaby's case, this means that not only would Mr. Huckaby have to pay tax on 100 percent of his income in New York, but his employer would have to pay tax on some portion of its income in Tennessee. If Congress takes no action on the "convenience of the employer" rule, look for states like Tennessee to get more aggressive with out-of-state employers who employ telecommuters like Mr. Huckaby.

Table 2: Most States Assert Tax Nexus on Employers Based on Presence of Telecommuting Employees

States That Assert Nexus over Employers Based on Presence of Telecommuting Employee	States That Do Not Assert Nexus over Employers Based on Presence of Telecommuting Employee
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Michigan, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia, Wisconsin	Connecticut, Mississippi
Note: Not all states responded to this particular question on the survey.	

Source: BNA's *2004 Survey of State Tax Departments*, Vol. 11 No. 4, S-26-27.

IV. Conclusion

A major tenet of sound tax policy is neutrality: the government should not encourage or discourage certain behaviors through the tax code. In the case of telecommuting, the “convenience of the employer” rule is acting as a direct financial disincentive for employers and employees to use telecommuting, since telecommuters can face double taxation on their income. Congress would be well advised to end this economic distortion by considering the Telecommuter Tax Fairness Act of 2005, which would allow states like New York to tax only their fair share of a telecommuter’s income, protect telecommuters from double taxation, and simplify the tax system for their employers.

Footnotes

1. *See In the matter of Thomas L. Huckaby*, 2005 NY Int. 51 (March 29, 2005).

2. *See* 20 NYCRR § 132.18(a).

3. *See generally* Chris Atkins, *Tax Foundation Background Paper* No. 49, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems" (September 2005), located at http://www.taxfoundation.org/news/show/1096.html.

4. *See* 20 NYCRR § 132.18(a).

5. *See* Id. ("…any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer.").

6. *See also Matter of Zelinsky v. Tax Appeals Trib.*, 1 NY 3d 85 (2003).

7. *See* Paul Korzeniowski, "Telecommuting Climate Getting Chilly," *E-commerce Times* (December 22, 2005), located at http://www.technewsworld.com/story/47786.html.

8. *See Complete Auto Transit v. Brady*, 430 U.S. 274, 287 (1977) (to pass Commerce Clause scrutiny a tax must be "fairly related to benefits provided the taxpayer.").

9. *See also* Chris Atkins, "Paying for "Civilized Society" in the Global Marketplace: H.R. 1956's Physical Presence Rule Accurately Matches Taxes Paid and Benefits Received," Tax Foundation *Fiscal Fact* (September 26, 2005), located at http://www.taxfoundation.org/news/show/1082.html.

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Tax Foundation
2001 L Street N.W., Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org