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State Withholding Taxes: Who, What, Where

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When it comes to payroll issues and withholding taxes, it is easy to decide to rely on your outside payroll service to determine the correct amounts to withhold. But the reporting and withholding requirements for employee compensation can be complex when multiple state jurisdictions are involved, and a payroll service can only rely on the information that they are given; it is up to the employer to gather the relevant information. For many New York law firms, the complexities come about both because you have employees who may live anywhere in the tri-state area, and because you have attorneys who may travel on business in and out of New York. As an employer with an office in New York, you are obliged to withhold New York State (and New York City, where applicable) income tax from several classifications of employees.

Withholding on Residents

New York employers are responsible for New York State withholding on the compensation paid to all New York residents, regardless of where the services are performed. For example, a New York resident who is assigned to a non-New York office, either permanently or temporarily, is still subject to New York withholding tax by a New York employer.

Withholding on Non-residents

You are also required to withhold New York State tax on all employees who perform services in New York, regardless of where they reside. This is true not only for employees who are regularly assigned to your New York office, but also for employees who are assigned to other offices and travel to New York to work for a short-term duration. Under New York law, there is no minimum length of time that a visiting employee has to be in New York to invoke the withholding requirement. However, under guidelines that New York State has issued to their tax auditors, employers will only be responsible for state tax withholding if an employee works at least fifteen (15) days in New York (excluding a reasonable number of training days). Note that the employee is still responsible to report New York-source income to New York State on his individual income tax return regardless of how many days he worked in New York.

Who is a Resident

While an employer can rely on the employee's certification of his residency status as long as the employer does not have any actual knowledge or reason to know the certificate is incorrect, it is important to understand what the residency criteria are. An individual is a New York resident if he is either domiciled in New York, or if he is physically present in New York for more than 183 days and maintains a permanent place of abode in New York for substantially all of the taxable year. A person is maintaining a permanent place of abode even if he is living in a company-owned apartment, if that person has primary or exclusive use of that apartment. A person is maintaining such abode for "substantially all" of the year if he maintains the residence for more than 11 months of the year. For example, an employee who transfers to New York in March of one year and leaves in November of the following year will not be considered a New York resident despite having spent more than 183 days in New York in each of the two years, because he failed to maintain a residence for "substantially all" of either year.

Temporary Assignment

Until 2009, it was possible for an employee to live in New York during a temporary work assignment and still not be treated as a New York resident if the work assignment was fixed and limited in duration, and was for the accomplishment of a particular purpose, e.g., an out-of-town attorney working in New York for two years in connection with specific litigation. However, this rule was repealed effective in 2009, and therefore a temporary work assignment will no longer be available as a way to avoid New York tax and the related withholding obligations.

Multiple States

Where an employee works in one state but resides in another, you may have a withholding obligation in both states depending upon whether you do business (i.e., have nexus) in each state. For example, a law firm with offices in New York and California will be required to track the time that employees spend in each state and withhold each state's income tax, subject to the 15 day rule discussed above for New York. Note that even in the absence of an office, the activities of your employees in a given state may create nexus for your firm. Where an employee works partly inside and partly outside New York, you must withhold New York tax on all of his income unless the employee provides an estimated percentage of services performed in New York, or you maintain adequate records to determine the correct amount of wages that are attributable to New York.

Telecommuters

New York has been particularly aggressive in taxing "telecommuters," i.e., those who work from home. While a law firm may not think of itself as having telecommuters, many attorneys who normally work in New York will also work at home and bill for that time. Those employees who live outside of New York may then attempt to characterize those services as having been performed outside New York, but New York State has consistently and successfully challenged such a position. If the services are performed by necessity at a bona fide work location outside of New York, then those services can be considered non-New York services. But if the services are performed at home solely for that employee's convenience, then those services remain New York-sourced. There are detailed guidelines issued by New York State to distinguish "necessity" from "convenience," and these guidelines make it difficult to demonstrate "necessity."

Reciprocity

Although New York does not maintain any reciprocal agreements with other states regarding withholding on non-residents, you should note that there are a number of states that do provide exemption from withholding for non-residents who reside in neighboring states, e.g., New Jersey and Pennsylvania exempt each other's residents from withholding.

Voluntary Disclosure

There may be situations where a firm now realizes that it has not been complying with the withholding requirements, but would like to do so in the future. In such situations there is often a concern that a change in filing position may trigger a state audit that will discover many years of incorrect treatment. To remedy non-compliance and encourage taxpayers to comply in the future, New York and most states have what is called a "voluntary compliance" program, under which taxpayers that come forward voluntarily can receive an agreement from the state to waive penalties, and limit the look-back period (i.e., the period of past non-compliance) to an agreed-upon time frame, usually three years.

Summary

The rules discussed above are generally applicable to states other than New York as well, but are not applicable to the partners of law firms, who are considered self-employed and are therefore generally responsible for their own tax obligations.

The steps that an employer needs to take are to determine:

- The states in which the employer has withholding obligations, based upon nexus.
- Each employee's state of residence; this is usually done by relying on the employee's certification.
- The state in which each employee performed services; many firms are able to track the location of the employee's services through his time entry or billing software.

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