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The Future of Work and Tax Policy Considerations — Part 1: Workforce Mobility

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The Covid-19 pandemic has disrupted all aspects of our lives, including our connections with friends, our roles in the community, and our functions at work. The school closures in March sent millions of children home for distance learning, and the subsequent stay-at-home orders had workers scrambling to adjust to the new work-life environment. As the economy gradually reopens and workers are allowed to return to the workplace under new health and safety protocols, many companies still encourage remote work. In the meantime, employers are evaluating whether or not this pandemic-induced, remote-work arrangement is a viable long-term option. This issue brief, the first of a two-part series, discusses some of the tax policy considerations of an increasingly mobile workforce. The next brief will examine the changing definition of “employment” and the associated tax implications.

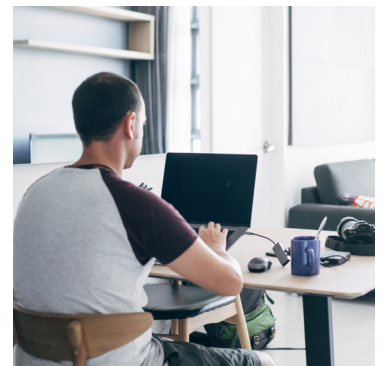
REMOTE WORKFORCE STATE TAX ISSUES

Survey data shows 30% to 60% of U.S. workers telecommuted in March and April, a much higher percentage than before the pandemic.¹ Some people worked from their homes and were not far from their offices, whereas others worked out of their vacation homes or family members’ houses, sometimes in another state. Although these arrangements may seem innocuous, they can trigger tax and other compliance issues for both workers and their employers.

For employees, states’ rules generally set out that employee wages are attributable to the state where the employee performs his or her work, which means an employee’s physical location dictates where the state personal income tax is due. For many employees, their physical location (where they work), their employers’ place of business (where their employers’ offices are located), and their residence (where they live), are in the same state. However, for workers who telecommute, two or three of these locations may not align. For instance, employees could be working in a different state from where their employers’ offices are located, and their residence could also be in a state that is different from where they perform their work.

The mobile workforce issue is not new, but the number of taxpayers affected has been increasing due to the advancement of information technology and the proliferation of digital platforms; the number surged this year because of the pandemic. Traditionally, affected workers are the ones who live close to state lines and commute to a different state to work. As a solution, about 16 states and Washington, D.C. have reciprocity agreements with neighboring states that allow these workers to file and pay taxes in their state of residence,² which provides certainty to taxpayers and avoids double taxation.³

For employees temporarily displaced by the pandemic and working from another state, slightly over a dozen states



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and Washington, D.C. issued guidance, confirming these remote workers will not be considered in-state workers.⁴ Most, but not all, of these states also clarified issues regarding nexus, wage withholding, and income tax reporting for employers (discussed further below). The remaining states that have not provided relief or guidance include Connecticut, New York, Delaware, Nebraska, and Arkansas, states with “convenience of the employer” rules. These rules essentially specify that if an employer’s office is in one of these states, an employee’s wage will be taxed as if it’s earned in that state, even when he or she works remotely. The rule stipulates that because an employee works remotely out of his or her own convenience instead of being required by the employer, the worker is still responsible for paying taxes in the employer’s state.

Although it is highly debatable whether the relocation of employees is done for their own “convenience” during the pandemic, some states are still enforcing convenience rules, whereas others will follow the employee physical presence rules outside of the state’s emergency order coverage period. For instance, New York Governor Andrew Cuomo stated that unless New York receives additional federal government assistance, the state will still seek to tax the income of nonresident workers, including health care workers who came from other states to help with the pandemic.⁵ In addition, although Massachusetts and Indiana provided relief for remote workers, these states indicated their exemptions are linked to the applicable periods of the state emergency orders, and remote workers who remain in the state afterwards will be subject to tax.

For employers, having employees working in another state typically creates “physical presence,” a key element of establishing nexus. Nexus generally refers to a sufficient level of connection between the taxing state and the taxpayer, such that the state has the power to impose taxes on the taxpayer.⁶ Having nexus in a certain state could lead to several state taxes, including income, sales and use, or gross receipt

taxes; there could also be city, county, or municipal-level taxes. For the states that have not provided comprehensive guidance, or, to the extent the guidance is inconsistent across states, the issues can quickly become complicated for employers.

When a multistate business determines the amount of taxable income attributable to a particular state, an apportionment formula is used to determine the proper share of the company’s income derived from that state. Most states either use a three-factor formula based on the company’s sales, payroll, and property in that state, or a single factor formula of sales to determine the amount of taxable income that belongs to the state.

A lack of remote worker relief at the state level could mean that, when an employee is physically present in a state where the company typically does not have nexus, the state can assert the wages paid to the employee contribute to the payroll factor of the formula. In addition, the remote workers may possess inventory or company-provided equipment, including computers or printers, at the employees’ physical location. Some practitioners believe this could add to the employers’ computation of property in the apportionment formula.⁷ Finally, although most states source the revenue from the provision of services to a state where services are delivered or received (market-based method), some states require service revenue or revenue from licensing of intangibles to be sourced to the state where the income-producing activity occurs, based on the relevant costs of performance (COP method).⁸ In other words, these states can claim that the compensation paid to employees who are telecommuting from their states contributes to the generation of revenue, therefore requiring some of the revenue to be sourced to those jurisdictions.

Besides income tax considerations, employers also need to comply with other tax and labor-related rules. Practitioners generally recommend employers perform “nexus tracing,” which essentially allows them to track where their employees are

working. This not only avoids tax filing or payment surprises for employers in the tax-filing season, but also allows employers to accurately fulfill tax withholding obligations. From a non-tax perspective, employers need to observe labor and employment laws in states where their employees are located.⁹ A wide range of additional issues may need to be considered, including wage and hour rules, termination of employment requirements, paid sick and family leave rules, employers' obligations regarding workers' compensation insurance, and unemployment insurance payment. In certain cases, states may require a company to register in order to do business in that state.

Although states, employers, and workers were all suddenly forced into remote work settings due to the Covid-19 pandemic, it has provided an unexpected opportunity for states to expedite the discussion about how best to tax an increasingly mobile workforce. Federal proposals in 2016 and 2019 attempted to provide consistency by prohibiting states from taxing non-physically present workers, which would essentially invalidate the "convenience of employer" rules.¹⁰ None of the proposals advanced. A few months ago, the Remote and Mobile Worker Relief Act of 2020 proposed to tax workers either in their state of residence¹¹ or in the state where they are physically present. Business communities largely favor this proposal because of the compliance challenges generated by states' sporadic and inconsistent actions. However, observers believe the bill has a slim chance of becoming law, because a federal preemption of state tax matters is typically not welcomed by states.

With no acceptable federal solution in sight, the clear immediate step is for states that have not issued guidance about 2020 to clarify that the presence of remote workers during Covid-19 is insufficient to create nexus. In the long term, although employers may not shift to a complete remote workforce, an increasing number of workers may spend a higher percentage

of their time working at home or following alternating telecommuting and in-office schedules. Several economists predict the number of remote workers will triple after the pandemic.¹² As a result, a consistent, simplified set of rules across states will not only reduce businesses' compliance burden, but also facilitate the development of a mobile workforce.

HOME OFFICE EXPENSE TAX BENEFITS

Out of necessity, most workers have learned to work effectively from home and to interact with others remotely. In many cases, both businesses and workers have made infrastructure investments to enhance productivity. These investments may include purchasing computer hardware (laptops, printers, monitors, headphones, video cameras, recorders, etc.), software (for remote meetings, document processing, or team collaboration), office furniture (desks, chairs, lamps, etc.), or services (faster internet connections, subscriptions to cloud-based services, etc.).¹³ The current tax system has different rules to account for these expenses depending on whether the worker is an employee or a self-employed individual.

Home office expense deduction is likely to provide some tax relief for self-employed workers. Prior to the pandemic, many workers chose to apply the simplified method, which provides taxpayers a deduction of \$5 per square foot for qualified businesses using a home, instead of the standard method that requires the calculation of actual home office expenses.¹⁴ Furthermore, the simplified deduction method limits the home office to 300 square feet, therefore generating a maximum deduction of \$1,500 per year.

Work-from-home orders may encourage self-employed individuals to expand their utilization of their home offices or to purchase additional equipment, making it more beneficial to select the standard method. In this case, although the deduction is not limited to \$5 per square foot, taxpayers need to maintain records to determine actual expenses, including

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partial deduction for expenses like utilities, mortgage interest, rent, depreciation, property tax, and insurance. However, if a taxpayer works from home as a self-employed individual in 2020, the tax benefits cannot be claimed until he or she files the 2020 income tax return next year.

Under both methods, workers need to regularly and exclusively use their home space for work to qualify for these deductions, meaning that they cannot use the space for both business and personal purposes. Some self-employed individuals advocated for additional flexibility from the Internal Revenue Service (IRS) regarding the exclusivity requirement for 2020, because many workers' personal and professional lives are essentially blended during the pandemic.

In contrast to the self-employed workers who can deduct home office expenses on their income tax returns, employees are generally unable to do so. The Tax Cuts and Jobs Act of 2017 eliminated certain itemized deductions from 2018 to 2025,¹⁵ including unreimbursed employee expenses such as home office expenses. As a result, there is limited room for employees to claim deductions of expenses associated with setting up a home office during the pandemic on their personal income tax returns.

Instead, the tax benefits could be initiated by their employers. Some observers state that employers can still reimburse employees for home office-associated expenses under Section 139 of the Internal Revenue Code,¹⁶ which allows reimbursement for reasonable and necessary personal, family, living, or funeral expenses as a result of an eligible disaster.¹⁷ Under this provision, expenses—including utility costs and computer and equipment costs—may all qualify for reimbursement. These expenses are essentially exempt from tax, as they are not included as a part of employees' federal gross income and, at the same time, are deductible by the company.

Therefore, if an increasing number of employees routinely work from their home offices in the future, a policy option worth considering is allowing either a portion of

employees' home office expenses or a fixed amount to be deductible by the employees. This deduction will be most relevant to the extent that employers do not reimburse employee home office expenses¹⁸ or the expenses that employees otherwise would not have incurred if they worked on the employers' premise.

REIMAGINING EMPLOYEE BENEFITS

An attractive tax benefit for over 5 million working parents is the dependent care flexible spending accounts (FSAs) provided by their employers.¹⁹ The FSAs allow employees to elect up to \$5,000 pretax earnings annually to pay for childcare expenses for children under 13 or elderly dependents.

Typically, unused amounts at the end of the program year are forfeited, making it a "use it or lose it" program. The Covid-19 pandemic resulted in many cancellations for daycares, summer camps, and after school programs, generating concerns that the unused amounts in the FSAs would be trapped and eventually lost. In response, the IRS provided relief in May to allow more flexibility for FSA programs if employers opt-in to allow these changes.²⁰ These include extended periods for claiming qualifying expenses, the option for midyear changes to elected amounts, and the option for multiple modifications. Similar flexibility is also permitted for employer-sponsored health care FSAs, an even more popular program used by more than 22 million workers.

The technology-enabled remote work environment created several emerging benefit coverage issues. In the field of medical expenses, although the IRS has specifically stated that telemedicine expenses²¹ are qualified expenses for health care FSAs and health savings accounts (HSAs, another similarly tax-favored account for high-deductible health plans),²² there have been cases where insurance companies denied coverage for telehealth claims, indicating only in-person visits qualify for insurance coverage.²³ Thus, patients will have to use FSAs or HSAs for unreimbursed expenses. On the other hand,

the pandemic has generated a discussion about what constitutes “childcare” in terms of FSA coverage. For instance, with a generation of Zoom-savvy young children in the making, can a work-from-home parent hire a virtual babysitter or register children for online activities and claim these as eligible dependent-care FSA expenses?²⁴

Two other employee benefits that have been gaining ground during the pandemic are paid family leave and paid sick leave programs. Prior to the pandemic, no federal law required employers to offer paid sick leave for workers’ short-term health needs or paid family leave for their long-term health conditions. As a result, most coverage has been discussed at state or employer levels. The situation temporarily changed when the Families First Coronavirus Response Act,²⁵ the federal government’s second Covid-19 relief package, provided paid sick leave and paid family and medical leave to control the spread of the virus. However, these provisions are set to expire on December 31, 2020.

For workers who do not have paid family leave or paid sick leave coverage through their states or their employers, being able to work remotely during the pandemic offers somewhat similar, positive results to what the paid family or medical leave benefits aim to accomplish. As a result, after the pandemic recedes, companies without these benefits may be able to offer telecommuting as an experiment before implementing a more comprehensive paid leave program. For instance, if a new mother works from home, she could use breaks from work to interact with her newborn child, who would be cared for by a babysitter or family member on site.²⁶ Without the commute time, new mothers could compress their work hours, save childcare costs, and feel less stressed. However, these telecommuting benefits should be viewed as complements instead of substitutes to the advantages of paid family or paid sick leave.

ADDITIONAL CONSIDERATIONS

The remote-working environment during the pandemic enables the discussion of extending the arrangement long term. Remote work is likely to become a more common option for businesses. Many workers view working from home as one of the most desirable benefits, and companies view telecommuting as a way of saving costs and reducing employee turnover.

Although the pandemic and the resulting telecommuting arrangements will not have the same effect on all jobs, there is no doubt that the overall workforce will be increasingly mobile and not tied to a specific jurisdiction. State tax and regulatory issues, home office reimbursement for employees, and workplace benefits are great starting points to engage in tax policy dialogues for tomorrow’s workforce and the future of work.

However, as we contemplate how best to design tax policies to accommodate a growing mobile workforce, it is important to bear in mind that not all work can be done remotely. A group of economists recently estimated that about 40% of jobs can be performed remotely, though these tend to be higher-paid, professional, service-related positions.²⁷ Many essential workers, on the other hand, are less likely to telecommute. As such, although the future points to an increasing number of remote work arrangements, the movement is likely to be industry, company, or task-specific. Although workers with lower mobility may not face state tax nexus issues and are less likely to need home office tax deductions, they can similarly gain from the conveniences provided by technology; employee benefit and labor protection measures such as paid sick leave and FSA coverage are equally important to them.

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