BY JEFFREY S. REED

COVID Dislocation and State Income Tax

The COVID-19 pandemic has resulted in mandatory nationwide office closures, leading many Americans to work from new locations. It is not uncommon for workers to now be performing work in a different state than the one in which their office is located. And some workers have decided to move permanently or temporarily to a new state for a change of scenery until the pandemic clears. This phenomenon may not end anytime soon, either – a major tech company recently announced that employees can continue to work from home until June 2021. Other large employers are likely to require or permit telework for the foreseeable future.

What are some of the major state income tax impacts of workers changing where they work on account of the pandemic? This article focuses on three areas: (1) nexus; (2) sourcing; and (3) residency. They will be discussed in turn.

Nexus and Telecommuting

On the whole, state revenue departments have been only moderately aggressive in asserting that companies with in-state teleworkers have nexus, often choosing to look the other way so long as employees working from home do not use their homes like a company office. This is a sensible position, as a company should not itself be considered "doing business" in a state within the meaning of state nexus statutes merely due to the presence of an employee or two working at home on their computers and not engaging in any public-facing activities for the company within the state.

The New Jersey Division of Taxation has taken a harder line on this issue to the point of litigating the position that the presence of a single teleworker in the state creates nexus. This position was upheld against a Maryland corporation with only one in-state teleworker. The teleworker was working from home in New Jersey and was not performing customer-facing activities at his home in New Jersey or elsewhere in New Jersey.[1]

In light of nationwide office closures, teleworking nexus is of course a much bigger issue than it has ever been before. As best as can be determined at this early juncture, it looks like the majority of states will be reasonable and forgiving about asserting nexus solely due to the in-state presence of employees who are working from home temporarily due to COVID-related office closures. Some state revenue departments have already announced policies to this effect.[2]

The bigger question is in the long term. If, as expected, COVID results in telecommuting becoming extremely popular, with more and more workers fulfilling their work responsibilities remotely and in different states than where a company has offices even after the pandemic ends, at some point it would not be surprising if more states add questions to their nexus questionnaires about whether there are any in-state employees working from home, and the position taken by the New Jersey Division of Taxation becomes the rule rather than the exception.

Receipts Factor Sourcing

COVID dislocation has the potential to materially impact receipts factor sourcing. For example, a customer may now want goods shipped to a new state to reflect a new home or a new working location. Changing the shipping address to a new state will generally impact sourcing, as most states use an ultimate destination rule for sales of tangible personal property, which will generally be the state in which the customer receives the goods.

COVID dislocation likewise has sourcing implications for service providers, who generally are required to use one of two methods to source receipts, depending on the state: (1) the location of the customer (AKA, market-based sourcing); or (2) the location of the service provider.

In market-based sourcing states, it is possible that the benefit of the service may now be received in a different state if the recipient of the service has changed states due to COVID dislocation. It is also possible that the nature of the service may have changed in response to COVID (for example, a service ordinarily provided in-person is now being provided online) such that the benefit of the service received has changed and the receipts should be sourced to a different state than was originally anticipated.

COVID dislocation has a more immediate and obvious impact in jurisdictions that source services using the location of the service provider. Of course, in light of teleworking it is possible that many services are now being provided from a different location. But a question is whether the company knows where its service providers are now located as they are providing the service. Articles in the popular press have been reporting that hedge fund managers are diligently tracking their work locations out of New York City during the pandemic as a way to reduce their New

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York City Unincorporated Business Tax liability.[3] To give the sense of the magnitude of this issue, the articles quote sources estimating that the City could lose hundreds of millions of dollars in unincorporated business tax as a result of hedge fund managers providing services out of the city on account of COVID dislocation. While in other jurisdictions, the impact of this issue is unlikely to be as material, the same sourcing issue, and potential for tax savings (albeit on a smaller magnitude) exists in all jurisdictions that source service receipts based on the location of the service provider.

Residency Changes

Flight from large cities to suburbia has been one consequence of the pandemic. There are regular profiles in the press of well-heeled professionals purchasing new homes in remote locations to guarantee that it will be easy to maintain six feet of distance from other human beings. Some of these purchasers will never return to their old homes and may already be looking to sell them. Others will retain their old homes indefinitely, maybe for investment purposes, maybe to hold open the possibility of returning once the pandemic clears.

Lots of individuals have questions about what this means for state tax residency. In particular, they wonder whether they have ceased to be a resident of a high-tax state. Although states have different residency rules, a general rule is that an individual will be taxed as a resident in the state where the individual's real, true, and permanent home is located. In the case of individuals who purchased new homes in new states in 2020 to escape pandemic hotspots, it may be tough to convince auditors that their true and permanent home changed for the year if they immediately return to their previous home in 2021 or whenever the pandemic ends.

On the other hand, there are plenty of individuals who were already contemplating moving to a new state before the pandemic struck – COVID just provided additional impetus to pack their bags. In the case of these individuals, assuming that their old homes have been sold or at least are on the market, and they do not return for any lengthy period over the next few years, they will have a strong position that they were only part-year residents of their old state for 2020 and became residents of their new state upon moving there.

It is hard to estimate the extent of the nationwide movement spurred by the pandemic. But it would not be surprising if there are more state residency changes in 2020 than in any year in recent memory. One thing to watch will be whether states on the whole start auditing residency issues more aggressively. Currently, California and New York have robust residency audit programs. But many other high-tax states do not. It would not be surprising if some state revenue departments look to beef up their residency programs trying to make sure they are not missing out on any tax dollars that might be theirs resulting from movement between states.

Conclusion

The COVID-19 pandemic has caused office closures for the foreseeable future. Employees are now working remotely in different locations across the United States and even internationally. Teleworking may continue to be popular even after the pandemic ends. From a state income tax perspective, the movement of individuals and the expansion of telework creates nexus, sourcing, and residency issues as discussed in this article. ■

1 *Telebright Corporation, Inc. v. Director, New Jersey Division of Tax'n*, 424 NJ Super (NJ App Div. 2011) (NJ 2011).

2 *See, e.g.,* Georgia Department of Revenue Corona Tax Relief FAQs, providing for relief if there are employees in the state during the pandemic and also providing for a 14-day post-pandemic grace period.

3 *See, e.g.,* "New York City Hedge Fund Managers Aim to Avoid City Tax by WFH," Wall Street Journal by Josh Barbanel (June 14, 2020).