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Tax Alert 2020-10

The coronavirus (COVID-19) Pandemic: Impact of Working from Home

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INTRODUCTION

The coronavirus (COVID-19) pandemic has raised concerns for all of us. While health concerns are our first priority, the current environment presents other challenges, as well. The federal government has advised all Americans to practice social distancing and take other precautions. Most states have taken stronger actions by issuing stay-at-home orders for all but essential activities. Although some states have begun to ease some of these restrictions, it is possible they may be reinstated, if necessary. According to a survey reported in the Wall Street Journal, nearly 50% of the U.S. workforce has been working remotely as a result of the coronavirus. In this Tax Alert, we discuss some of the tax issues employers need to consider as their workforce location changes. We also discuss some tax issues employees need to consider with regard to working remotely, whether from home or another location.

It's Mid-2020: Do You Know Where Your Tax Home Is?

Many state governors issued stay-at-home orders in response to COVID-19. In response, many employers have allowed (or required) employees to temporarily perform their work duties at home. "Home" may be in the same or a different state from the employer. For some, "home" may be their usual residence and for some it may mean their vacation home or even their parents' home. This temporary change raises several important tax issues, including state tax residency for a full- or part-year.

There is no one rule that applies to all states. Instead, there are a number of rules that may apply: some states tax individuals if they are domiciled in the state (intent test), some if they are statutory residents (number of days test), and some if the worker is there even for just a few days.[1] These general rules are not mutually exclusive and a state may impose tax based on all three. As of early June, 13 states and the District of Columbia announced that they will not tax individuals who are working remotely in those states due to the coronavirus. About a dozen states already have agreements with their neighboring states allowing them to pay taxes where the employee lives rather than where they work. Taxpayers should be mindful of this changing landscape and pay attention to the rules of their "home" state and the rules of the state in which they are working remotely.

AUTHORED BY:

National Wealth Strategies, Chief Investment Office

Information as of June 12, 2020 and subject to change.

[1] All states with an income tax generally assess income tax on two types of income. First, the state taxes "residents" of the state on all (or most) income earned, whether that be from wages, dividends, interest, gains, etc. Most of these states also assess income tax on what can loosely be described as "source income"—i.e. any individual who is not a "resident" of the state will nevertheless be subject to state tax on income earned that is "related to" (or sourced) in that state. Such sourced income typically includes income on a business being conducted in the state, rental income derived from real estate located in the state, etc. Many states have expanded the concept of "sourced income" to include wages on services performed in the state as an employee of a business that is not necessarily located in the state.

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Home Office Expenses

In order to reduce the risk of contracting or spreading the virus, many employees have been working from home, sometimes mandated by their employers and sometimes for their own concerns and convenience. This raises the question of whether employees may claim an income tax deduction for expenses related to their so-called home office, such as office supplies, new equipment and other expenses. Some employers have been providing their employees a monthly allowance for their additional expenses while working remotely. We address that issue in the next section.

Home office deductions. Generally, under Internal Revenue Code (IRC) Section 280A, deductions for business expenses with respect to a dwelling unit used by the taxpayer during the taxable year as a residence are disallowed. However, there is an exception for expenses attributable to the business use of a home, but only to the extent of the gross income from such use. To satisfy the business use qualification, the dwelling unit (or portion thereof, such as a specific room) must be exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer. In the case of an employee, the exclusive use must be for the convenience of the employer.[2]

Miscellaneous itemized deductions. Even if an expense is allowed under federal tax rules, a deduction may nevertheless be disallowed under IRC Section 67. The 2017 Tax Act (we have a separate *Tax Bulletin 2018-1: Tax Reform Signed into Law*) amended Section 67 to disallow "miscellaneous itemized deductions," including unreimbursed employee business expenses, for tax years beginning after 2017 and before 2026. Miscellaneous itemized deductions are defined as all itemized deductions, except for certain specifically enumerated items. Miscellaneous itemized deductions include the deduction for trade or business expenses. Prior to the 2017 Tax Act, such miscellaneous itemized deductions were allowed to the extent the total of such deductions exceeded 2% of adjusted gross income (referred to as the 2% floor). At least until 2026, a business expense deduction for home office expenses is generally not allowed under Section 67.

Fringe Benefits

In conjunction with employees working from home, an employer may pay various expenses on their behalf, such as transportation, meals, office supplies and computer/telephone conferencing equipment. This raises the question of whether any such items are includible in the employee's income.

Income inclusion. Pursuant to IRC Section 61, there is a very broad definition of items includible in gross income. The statute specifically includes in gross income: "compensation for services, including fees, commissions, fringe benefits and similar items."

Working condition fringe benefit. Pursuant to IRC Section 132, certain fringe benefits are specifically excluded from gross income. One of the key exclusions is the "working condition fringe." The total value of a qualifying working condition fringe is excluded from an employee's income. A working condition fringe is defined as "any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under Section 162 (trade or business expenses) or Section 167 (depreciation)."

By referencing this exclusion to trade or business expenses, the exclusion covers such items as traveling expenses, meals and lodging, an office, a secretary, support staff and office supplies. However, there may be circumstances where the treatment of a fringe benefit for an employee working in the office may be different than for an employee working at home. For example, consider the case of employer-provided meals to employees in the office. Depending on the circumstances, it may be more difficult to justify the fringe benefit exclusion for employees working from home.

Commuting. Generally, commuting expenses incurred by an employee in traveling between their residence and office are nondeductible personal expenses. Accordingly, if such expenses were paid by the employer, the employee would not be eligible for the fringe benefit exclusion. However, if the taxpayer's sole or principal business location is their residence, all of their local transportation costs relating to the business are deductible.

Miscellaneous itemized deductions. As discussed above, the 2017 Tax Act temporarily disallows miscellaneous itemized deductions (including trade or business expenses under Section 162) for taxable years beginning after 2017 and before 2026. The Act does not amend the definition of working condition fringe benefit in Section 132. Due to the cross-reference in Section 132 to Section 162, it could be interpreted that the working condition fringe provisions are also temporarily suspended. However, this does not appear to be the case, based on *IRS Publication 15-B (Employer's Tax Guide to Fringe Benefits)*, as revised after the 2017 Tax Act. In that publication, there is no limitation of the working condition fringe exclusion based on the temporary disallowance of trade or business expense deductions.

It's Mid-2020: Do You Know Where Your Employees Are?

In response to COVID-19 and various stay at home orders, many employers have mandated, or allowed, employees to temporarily perform their work duties at home. "Home" may be in the same state as the employer or in a different state. As previously addressed, such changes have implications for employees. Such changes also raise two important issues that can expose companies to sales and income taxes, and compliance issues. For instance, will the "new" location of the employee cause the employer to have a nexus with the employee's state and will the location of the employee cause state income tax withholding requirements.

[2] A discussion of these rules is contained in IRS Publication 587, Business Use of Your Home.

Nexus and State Income Tax Withholding.

Nexus with the State—Employers with a connection to a particular state—a so-called nexus—may be under other tax obligations, such as the collection of sales tax and the payment of income tax on earnings allocated to the state. States have responded in a variety of manners due to the change in location of employees because of the pandemic. For instance, New Jersey issued guidance stating it will "temporarily waive the sales tax nexus standard which is generally met if an out-of-state seller has an employee working" in New Jersey. Under the guidance, remote sellers will not have nexus for sales tax purposes in New Jersey during a temporary suspension period if they have not maintained a physical presence in New Jersey—other than having employees work from home in the state—and they fall below the state's economic nexus thresholds. Other states have taken a similar approach.

Income Tax Withholding—It is important for companies to keep track of where their employees work and reside. In general, state income tax withholding is required in the state in which the employee's services are performed, not the state in which the employee resides. There are exceptions if the working state does not impose an income tax or if a reciprocal agreement exists between the working state and the residence state. States have reacted to this situation in a variety of ways. For instance, effective March 13 until September 30, 2020, South Carolina will not use the temporary change of an employee's work location to impose a South Carolina withholding requirement under state law. Therefore, an employee who works for an out of state employer but who now teleworks from their South Carolina home would not be subject to South Carolina income tax withholding. Other states have announced similar positions (but with time periods extending as far as December 31, 2020). Employee compensation is subject to Illinois income tax withholding when the employee has performed normal work duties in Illinois for more than 30 working days. If an Illinois resident employee has performed work for more than 30 working days from their home in Illinois for an out-of-state employer, the employer may be required to withhold Illinois income tax from the employee.

There is an increasing need for guidance on these issues on both a state level and a federal (and perhaps even an international) level. Some states have been lenient in their guidance; some states have been silent. If states take contrary positions in their guidance, the federal government may have to step in with a federal rule. A federal bill previously proposed is the Mobile Workforce State Income Tax Simplification Act. This bill would exempt workers from filing tax returns in a state if they work in that state for 30 or fewer days during a year. Such a bright line rule could ease the compliance burden and the uncertainty for employers, as well as employees.

As a result of more people working remotely, whether from home or elsewhere, employers and employees should be mindful of this in determining in which state to withhold income tax.

CONCLUSION

The coronavirus pandemic has had a profound effect on how we live and where we work. Those new arrangements may be temporary or may become more permanent. In this Tax Alert, we have explored some of the obligations and complexities facing employers as their workforce relocates because of the coronavirus. We have also summarized some of the tax implications faced by employees working from home or other remote locations. The guidance coming from state tax authorities should be reviewed frequently, as these issues are dynamic and ever changing. In order to understand how these changes may affect your situation, you should consult with your attorney or other professional advisor.

— National Wealth Strategies, Chief Investment Office

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