Understanding a state’s authority for requiring employer withholding is imperative for complying with state withholding laws.

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Over the last decade, multistate employers have witnessed notable increases in states' nonresident withholding enforcement efforts beyond the typically thorough audits by California or New York. During that same time, multistate employers have seen internal auditors question their policies and procedures related to state nonresident withholding compliance. Even the U.S. Congress has shown interest in multistate withholding simplification and uniformity.¹

While much of the discussions surround withholding state income taxes from the salaried or commissioned wages of multistate business travelers, and deservedly so, employers are also faced with state withholding compliance for various lump-sum payments, deferred compensation, or some combination thereof, made to those travelers. Employers of all sizes are adopting creative compensation packages for their workforces.

Though lump-sum and/or deferred compensation payments may be paid to all levels of employees within a company, these payments historically have been "low-hanging fruit" for state auditors because they typically represent substantial wages paid to high-ranking executives. As a result, unusual payments create nonresident withholding audit risk for many employers.
Despite the increase in nonresident withholding enforcement and compliance efforts, many states have not issued guidance on a wide variety of compensation types. To the extent states have issued topical guidance, the guidance may be dated or may only address specific forms of payments (e.g., stock options). Thus, employers that adopt creative or unique compensation packages may not have adequate guidance to comply with state withholding laws.

By discussing a series of recent state withholding guidance, this article explores the legal bases for withholding state taxes from deferred compensation and other special compensatory payments like non-compete agreements. As with any other state tax issue, each state's laws must be reviewed to ensure the correct amount of withholding.

For example, a state may make the decision to only require withholding from deferred compensation wages if the recipient is a resident of the state at the time the income is recognized for income tax purposes. Of course, a number of states do not impose an individual income tax on wages in the first instance.2

Overview of Employer Withholding from Nonresident Wages

Understanding a state's authority for requiring employer withholding is imperative for complying with state withholding laws.

A note on residency versus "source" (and attempts to mitigate double taxation and double withholding)

States impose individual income taxes and the correlative employer withholding obligations based on the employee's residency and where the employee performs work for the employer (i.e., "source").3 This article focuses on a state's authority to tax based on the source of a nonresident employee's wages.4

To reconcile the potential for multiple taxation of an employee's wages when the employee performs services throughout the United States, states generally provide residents a credit for taxes paid to other jurisdictions.5 In anticipation of the credit for taxes paid, and consistent with the policy that withholding should approximate individual income tax liability, many states have enacted laws or adopted policies that mitigate or eliminate the potential for double withholding by employers.6 Other states also alleviate double taxation and withholding by entering into reciprocity agreements with other states, usually with
surrounding states, whereby the employer only withholds tax for the employee's state of residence so long as certain administrative requirements are met.7

**Amount of withholding—taxable "wages"**

States that impose individual income taxes require employers to withhold tax from all wages paid to resident employees and from all wages derived from services performed in the state by a nonresident employee.8 For example, North Carolina requires employers to withhold income tax from wages and salaries of all residents regardless where earned and from wages of nonresidents for individual services performed in the state.9

The amount of state withholding generally is intended to approximate the amount of tax that the resident or nonresident employees will owe when they file their state individual income tax returns. California's relevant withholding statutes, like Georgia's and Maine's, provide that the withholding tax is to be computed in such a manner as to produce an amount that is "substantially equivalent" to the amount of individual income tax "reasonably estimated to be due" if the wages subject to withholding are included in the employee's gross income.10

States require employers to withhold tax from "wages," which may be broadly defined and/or tied to the Internal Revenue Code's definition of "wages" for federal withholding tax purposes.11 While there are certainly complications in determining whether wages are subject to withholding, employers with traveling employees more often struggle with allocation or apportion issues with deferred compensation and lump-sum compensatory payments to business travelers. In the context of multistate employee withholding, one of the more vexing questions is how to divide up the "wage" pie (allocation or apportionment of wages) rather than how to combine the pie's ingredients (taxable wages).

**Withholding thresholds**

State withholding rules have been described as a "patchwork of laws" because they are non-uniform and vary not only from state-to-state but also from withholding to individual income tax.12 Arguably the biggest impediment for employers is the variety of nonresident withholding "thresholds," *i.e.*, the event that triggers an employer's withholding obligation in a given state.

These withholding thresholds may be based on working days that an employee is in the state, wages paid to an employee for services performed in the state, or some combination of those criteria. Other states
have not adopted a bright-line withholding threshold, but instead require an employer to withhold if it pays wages that exceed the individual income tax filing requirements (after individual exemptions) to an employee for services performed in the state. Importantly, employers that are not required to withhold from an employee's wages nonetheless may be required to report such wages as state-sourced on the employee's W-2.13

In the area of state withholding, New York arguably has the most robust set of guidance of any state and regularly audits the nonresident withholding compliance of employers engaging in business in the state. For these reasons, New York's withholding rules serve as the touchstone for many employers seeking to establish national withholding policies.

For example, it is well-known that New York adopts a bright-line "14-day rule" withholding threshold.14 Under New York's 14-day rule, an employer is not required to withhold tax from an employee's compensation if it reasonably expects that employee to spend 14 working days or less in the state.15

The following are examples of the varying, and often irreconcilable, state approaches towards withholding thresholds for employers with nonresidents working in the state:

- **Connecticut:** In general, an employer maintaining an office or transacting business in Connecticut and making payments of taxable wages must deduct and withhold individual income tax from such wages paid to residents and nonresidents.16 But similar to New York's "14-day rule," the Connecticut Department of Revenue Services adopted a *de minimis* withholding rule applicable to nonresident employees. As explained in the Department of Revenue Services' detailed guidance on Connecticut's so-called 14-day rule, employers are not required to withhold Connecticut income tax from wages/compensation paid to nonresident employees for services performed in Connecticut provided the employees are assigned to a primary work location outside of Connecticut and work in Connecticut 14 or fewer days during a calendar year.17

- **Arizona:** Every employer at the time of the payment of wages, salary, bonus or other emolument to any employee whose compensation is for services performed in Arizona is required to deduct and retain from the compensation an amount prescribed by tables adopted by the Department.18 No withholding is required from wages paid to nonresident employees if the nonresident employee is in Arizona less than 60 days a year for the purpose of performing a service for the benefit of the employer, subject to various exceptions.19

- **California:** An employer is required to withhold California tax from all payments or distributions, including wages paid to an employee, of California source income in excess of $1,500 during the
calendar year made to a nonresident employee. Although withholding must begin as soon as the total payments of California source income for the calendar year exceed $1,500, a catch-up withholding is not required on the first $1,500.

- **Georgia**: Georgia broadly defines "wages" to include all remuneration paid, including the cash value of all remuneration paid in any medium other than cash. However, the term "wages" does not include compensation paid for "nonresidents performing services in the state if employed in-state no more than 23 days in a calendar quarter...".

- **Maine**: Every employer maintaining an office or transacting business in Maine that pays wages to an individual subject to income tax must, if required to withhold federal income tax from those wages, deduct and withhold from those wages for each payroll period a withholding tax. Generally, employers who are required to withhold federal income tax from wages to a nonresident must also withhold Maine income tax from those wages if the wages constitute Maine-source income that is not excluded from taxation under Maine law. An employer is only required to withhold from Maine-source compensation for individual services if the nonresident employee is present in the state performing individual services for more than 12 days during that taxable year and directly earns or derives more than $3,000 in gross income during the year in the state from all sources.

- **Oregon**: Employers are not required to withhold Oregon tax from nonresidents who earn less than the Oregon standard deduction from in-state sources. For 2014, the Oregon standard deduction for single filers is $2,115 and $4,230 for joint filers (married/registered domestic partners).

It is important to note that the thresholds based on days worked in the state—in contrast with thresholds directly tied to the individual income tax filing threshold—typically do not apply to the individual income tax filing obligations of employees. This disconnect between the withholding and income tax rules may trap unwary employees who may not be aware of their filing obligations.

Furthermore, a state's withholding threshold may not apply to all forms of compensation and depend on the type of compensation and, of course, the state. For example, the New York Department of Taxation and Finance unequivocally explains that the 14-day rule does not apply to "[c]ompensation paid in one year that is related to services performed in a prior year. For example, deferred compensation and compensation from nonstatutory stock options." Other state guidance, if any, is less clear.

In contrast, states that have not adopted a bright-line withholding threshold like New York's 14-day rule, but rather adopt the individual income tax filing threshold as the withholding trigger, are more likely to apply their respective thresholds to all forms of compensation. Unfortunately, withholding thresholds are
usually low dollar amounts that could be triggered on the first day of service in the state as is the case in California and Oregon, described above.

**Limitations on federal preemption under the Source Tax Act**

It is important to note, as well, the narrow application of the federal Source Tax Act. The Source Tax Act prevents states from imposing tax on "retirement income" of nonresidents, irrespective of their residence status while earning the retirement income. "Retirement income" is limited to plans where payments are made in substantially equal period payments of not less than 10 years. Thus, the Source Tax Act does not preempt states from imposing nonresident withholding obligations on employers making lump-sum payments, payments made over the course of less than 10 years, payments not otherwise meeting the definition of "retirement income," or any payment made to a current resident of the state.

**Considerations When Evaluating State Tax Withholding Rules**

In light of the above complexities, which are merely the tip of the iceberg, it is no wonder employers with multistate business travelers have trouble complying with state withholding laws.

**Why the confusion?**

Specifically, the potential multiyear look-back period employed by a number of states, the differing allocation methods adopted by those states, and/or the inconsistent characterization of compensatory payments such as noncompete agreements or release of claims agreements, make for difficult state withholding compliance. But irrespective of the type of compensatory payments, there are themes to state guidance addressing payments other than ordinary salaried or hourly wages.

Depending on the level of analysis, a ten-year old ruling may indicate how a state auditor may view an employer's long-term bonus plan or release of claims clause payment in a separation agreement. As illustrated in the guidance below, states generally look to (1) the basis for the compensatory payment (e.g., consideration of prior employment and/or some future service or forbearance), and (2) the state or states where the activity/inactivity related to the basis for compensation occurred.

Individual income tax guidance may provide instructions for an employer's withholding obligations, keeping in mind a state's employer withholding threshold may differ from its employee filing threshold. As
discussed above, states that impose an individual income tax generally require employers to withhold tax from residents and nonresidents earning wages from in-state service in an amount "substantially equivalent" to the tax due from the employee with respect to wages paid in the calendar year.\textsuperscript{33} Thus, although many of the below rulings and cases deal with the individual's income tax obligations, not employer withholding, the decisions nonetheless are relevant to employers with traveling employees.

Importantly, some states may disregard the source-based analysis that forms the basis of the following guidance, taxing only residents at the time of recognition of the income at issue. Also, depending on the circumstances, an employer should retain arguments that it may not be required to withhold tax from that payment if it does not have the requisite contacts with a current or former employee's residence state to satisfy constitutional norms. Thus, an employer should always evaluate whether it has the obligation (e.g., because of substantial nexus in the state) in the first instance before withholding.\textsuperscript{34}

**Application of state (and local) withholding rules**

The application of the withholding rules to define compensation and other special payments in various jurisdictions is discussed below.

**Stock options, restricted stock, and other non-qualified deferred compensation**

*New York:* New York requires nonresidents who have been granted stock options, restricted stock, or stock appreciation and who performed services in the state during the grant period to allocate to compensation income from those items pursuant to rules established by the New York Department of Taxation and Finance.\textsuperscript{35}

For example, the Department of Taxation and Finance's allocation period for nonstatutory (nonqualified) stock options ("NQSOs") is the period of time beginning with the date the option was granted and ending with the date the option vested, which is the point at which all service-related conditions necessary for the exercise of the option have been met.\textsuperscript{36} If the option vests at the time of the grant, the allocation period is the same period of time that applies to regular, non-stock-based remuneration from the grantor during the taxable year the option was granted.\textsuperscript{37}

The New York Tax Appeals Tribunal recently addressed the taxation of NQSOs in *In the Matter of the Petition of Lawrence Gleason.*\textsuperscript{38} In *Gleason,* the Tribunal ruled that compensation received by a nonresident taxpayer from the exercise of NQSOs was allocable to New York and subject to New York individual income tax. The taxpayer's former employer granted him the NQSOs while the taxpayer was
employed, during which time he performed services on behalf of the employer in New York and other states. The taxpayer exercised the options in 2006 after he had retired, at which point the options had a negative aggregate value.

The taxpayer argued that the income derived from the exercise and liquidation of the options could not be income attributable to New York because the entire appreciation in the stock's value occurred after he terminated employment. Therefore, the taxpayer maintained that his option income lacked the minimal connection to New York that would allow taxation under the Due Process Clause of the U.S. Constitution. In response, the Tribunal first noted that the taxpayer inappropriately challenged the "apportionment scheme" that the state sought to apply to his income. Instead, the question presented was whether or not the income was subject to New York tax in the first instance.

The Tribunal, relying on the Court of Appeals decision in *Matter of Michaelsen v. N.Y. State Tax Commission*, concluded in *Gleason* the taxpayer's income derived from his stock options was subject to New York tax. The Tribunal explained that the taxpayer received the options for his employment in New York and the *Michaelsen* court found it reasonable to include market appreciation of stock up until the time when the options are exercised in determining the value of the compensation. Finally, the Tribunal rejected the taxpayer's dormant Commerce Clause argument because he failed to identify any discrimination against interstate commerce as applied to his circumstances.

**Connecticut:** The Connecticut Department of Revenue Services has adopted a series of regulations addressing specific types of deferred compensation, including incentive stock options, NQSOs, and other nonqualified deferred compensation. These regulations provide guidance for employers making such payments to resident and nonresident employees for performing services in Connecticut.

A taxpayer recently challenged the Department of Revenue Services' NQSO apportionment methodology. In *Allen v. Sullivan, Comm'r of Rev. Svcs.*, a Connecticut trial court held that the state may tax a nonresident on income realized from the exercise of NQSOs granted for services rendered in Connecticut. At the time each tranche of NQSOs were granted, they had no readily ascertainable fair market value. Over portions of the NQSOs' vesting period, the taxpayer was a resident of Connecticut and performed services on behalf of two employers, for which he received respective NQSO tranches as compensation.

The court rejected the taxpayer's claim that he was beyond the jurisdiction of Connecticut to tax the income from NQSOs even though he was a nonresident at the time of exercise. The court reasoned that the taxpayer's employer granted the NQSOs for services the taxpayer performed in Connecticut. Thus,
the court concluded that the Department of Revenue Services correctly treated the appreciation/gain as Connecticut source income, even though the taxpayer established residence outside the state when he exercised his stock options.

While not discussed in detail in the case, Connecticut apportions income from NQSOs based on the ratio of Connecticut source compensation to total compensation paid by the grantor to the grantee during the grant-to-exercise period. This apportionment method differs from New York's grant-to-vest allocation based on working days, California's grant-to-exercise allocation based on working days, infra, and other states' apportionment methodologies like Ohio's methodology based on the "Ohio-related appreciation" of such options.43

California: California agencies have published various forms of guidance that address the withholding rules for deferred compensation. In general, California requires nonresidents to apportion income from deferred compensation from the time first earned, such as the date of a grant, until the time the nonresident recognizes income, such as the date of vest or exercise.

For example, in *In Appeal of Lyon*, the State Board of Equalization ("BOE") ruled that a taxpayer was liable for tax on the gain from the sale of his employer's stock options even though he exercised the options when he was no longer a resident of California.44 The BOE explained that "the critical factor that determines the source of income from personal services is not the residence of the taxpayer, the place where the contract for services was executed, or the place of payment, but rather the place where the services are actually performed."45 The BOE also explained that, even though a taxpayer received gain from the sale of his employer’s stock options when the taxpayer was no longer a California resident, the gain represented compensation for services that were performed in California and, therefore, is subject to California individual income tax.46

Based on these decisions, the BOE ruled that the income in Lyon should be sourced to and taxed by California even if the taxpayer was a legal resident of another state at the time of exercise because the taxpayer was granted stock options by his employer as compensation for services he performed while working in California.47

More recently, in *Appeal of Kimball*, the BOE again ruled that the California Franchise Tax Board ("FTB") properly used the grant-to-exercise allocation method to determine California source income from NQSOs received by a California nonresident.48 Notably in Kimball, the BOE explained that an individual's compensation for individual services should be apportioned "in such a manner as to allocate to California that portion of the total compensation which is reasonably attributable to individual services in this State."
In a matter involving restricted stock units ("RSUs"), the FTB issued a Chief Counsel Ruling describing the proper apportionment method for sourcing income received by an employee who was granted RSUs as a California resident, but did not recognize income thereon until he was a nonresident. Because in the RSU context there was no "exercise" recognition event, the Chief Counsel ruled that the taxpayer must use a "reasonable apportionment method" to determine the portion of California source income received. And, according to the Chief Counsel, the most reasonable apportionment method to determine the portion of California source income received was to multiply the RSU compensation received by a ratio of California working days from the grant date to the vest date over the total working days anywhere during the same period.

The Chief Counsel noted that taxpayers were not limited to the working-days apportionment methodology, but the method generally had been determined to be a reasonable manner of allocation and appeared to be the most reasonable method that could be used under this taxpayer's facts and circumstances.

Virginia: The Virginia Department of Taxation explained the taxability of a lump sum nonqualified pension distributions from a nonqualified retirement plan to taxpayers who were residents of Virginia during the portion of the year in which the distributions were received. Prior to moving to Virginia and establishing domicile on March 7, 2010, the taxpayers (husband and wife) were residents of a state with no income tax. On March 1, 2010, the husband retired from the company operating in their residence state. The nonqualified distributions were earned and payable to the husband as of the date of his retirement, but were not processed and distributed until April 2010—after the taxpayers became residents of Virginia. The taxpayers filed their part-year Virginia return, attributing the nonqualified distribution to their former residence state, which conveniently did not impose an income tax. On audit, the Department of Taxation included the distribution in Virginia taxable income and the taxpayers appealed.

The taxpayers in P.D. Ruling 14-79 argued that the nonqualified distributions should not be subject to Virginia tax because they were deferred wages from the husband's employment in their former residence state. Hence, the taxpayers argued that, based on prior rulings, the nonqualified distributions should be allocated based on the grant-to-exercise method, described above, for nonqualified stock awards or options.

The Department of Taxation distinguished those prior rulings by explaining that the nonqualified stock allocation rules only apply to persons who are nonresidents at the time of exercise and where the income from such exercise is sourced to Virginia (e.g., because the nonresident-grantee earned the stock award
or option for services performed by the employer-grantor in Virginia). Specifically, the Department of Taxation explained, "[i]f the husband were a nonresident of Virginia when the lump sum nonqualified pension distribution was received, the income would have been treated similar to the Department's treatment of income from [incentive stock options] received by nonresident individuals."52

Under the facts of P.D. Ruling 14-79, however, the husband was a resident of Virginia at the time of distribution. As a result, that taxpayer's entire income wherever earned was taxable by Virginia, subject to credits for taxes paid on the same income to other states. Because the taxpayers earned the deferred compensation in a state with no income tax, no out-of-state tax credit was available to offset Virginia income tax attributable to the nonqualified distributions. If that other state imposed an income tax and adopted rules similar to Virginia with respect to deferred compensation, presumably the taxpayers' income from the nonqualified distributions likely would be taxed as "source" income and Virginia would afford a tax credit for those out-of-state taxes paid.

Finally, the Department of Taxation noted that the federal Source Tax Act did not prohibit taxation of the nonqualified distributions because at the time of recognition, the taxpayers were residents of Virginia.

**Georgia:** Effective for deferred compensation earned on and after January 1, 2011, Georgia taxes the income from performing services in the state during a prior year of a nonresident "who receives income from such activity in the form of deferred compensation or income from the exercise of stock options and such income exceeds the lesser of 5% of the income received by the person in all places during the taxable year or $5,000."53 "Deferred compensation" for Georgia income tax purposes means compensation received from a nonqualified deferred compensation plan, which in turn has the same meaning as defined in Internal Revenue Code § 3121(v)(2).54

The income earned by a nonresident from deferred compensation will be allocated based on the ratio of the days worked in Georgia for the employer to the total days worked for the employer.55 For example, the working days allocation for nonstatutory stock options that do not have a readily ascertainable fair market value are allocated to Georgia based on the working days in the grant-to-vest period of such options.56

Under compensation arrangements that do not meet the "deferred compensation" definition under O.C.G.A § 48-7-1(11)(E)(i), the Georgia Department of Revenue may require nonresident employees to allocate income to the state if they received such compensation for performing services in the state, even if such income is recognized in a later tax year.57
Ohio municipal corporations: Withholding issues related to deferred compensation are not limited to state-level income taxes. In *Nationwide Mutual Ins. Co., et al. v. City of Columbus Bd. of Tax Appeals, et al.*, the Ohio Board of Tax Appeals ("BTA") held that employers were required to withhold the City of Columbus income tax from distributions from a supplemental retirement plan (a non-qualified deferred compensation plan that is a defined benefit plan described in Internal Revenue Code § 3121(v)(2)(C)) to former employees. The BTA rejected the employers' position that the Columbus income tax ordinance required withholding only by employers from current employees—but not former employees.

The BTA explained that, under the Columbus ordinance, an employer is required to withhold the applicable income tax at the time of payment of such salaries, wages, commissions, or other compensation. The BTA reasoned that the taxpayer, by virtue of being the employer, became obligated to pay the compensation at a future time and was likewise obligated to withhold the tax at the time of payment, regardless of whether the plan participant was still employed at such time. While the taxpayer argued that the payments were exempt "pension" income, the BTA ruled that there was no support in the city ordinance for the proposition that it did not tax pensions.

Lastly, the BTA determined that the city ordinance did not operate in contravention of any state statute. That is, the state did not expressly preempt the city's right to determine the manner in which the subject tax should be withheld. Therefore, the city withholding ordinance constituted a valid exercise of the city's municipal power to tax.

Similar to *Nationwide*, the BTA ruled in *Boyer v. St. Bernard Municipal BOA* that the exercise of nonstatutory stock options by a nonresident when he no longer worked in the municipality did not preclude subjecting the options to municipal income tax. The BTA explained that the taxpayer earned compensation at the time the options were granted and the measure of that compensation occurred when exercised.

**Other compensatory payments**

States may also consider payments from covenants not to compete, release of claims, and other such agreements associated with severance packages to be taxable wages to the extent the activity (or inactivity) is attributable to services or doing business in the state. Connecticut and New York, among others, have addressed the taxability of such payments.

For example, in *In the matter of the Petition of Gail B. DeGroat*, the New York Tax Appeals Tribunal determined that the taxpayer, a nonresident who worked in New York for her former employer, did not
report as income a special payment that her former employer paid to her pursuant to a settlement agreement and release on her New York nonresident return. The agreement between the taxpayer and the former employer stated that the special payment was made in consideration for the taxpayer's settlement and release of any possible claims she might have had against her former employer. The agreement did not specify that the payment was made to settle any particular claim or claims the taxpayer may have had against the former employer. Accordingly, the Tribunal concluded that the taxpayer failed to show that the special payment was not derived from her employment in New York.

On several occasions, the Virginia Department of Taxation has issued rulings that analyze the basis of a compensatory payment before determining where such payment should be sourced for individual income tax (and hence employer withholding) purposes. For instance, the Department of Taxation has ruled that additional periodic payments received by a nonresident from a former Virginia employer for a promise not to compete are not income from Virginia sources and, therefore, are not taxable by Virginia. Even though the periodic payments in the termination agreement were labeled "severance," the payments were not made due to termination of employment but rather were compensation for a promise not to compete.

In contrast, payments made to a nonresident taxpayer by his former Virginia employer pursuant to a separation agreement were for severance from prior employment, not for a noncompetition provision, and therefore were subject to Virginia individual income tax. In that ruling, the Department of Taxation determined that severance pay is considered Virginia source income to a nonresident individual when paid by a Virginia employer.

Accrued vacation pay is another common payment to employees that they may earn over a period of years and be paid in a subsequent year or years, similar to other forms of deferred payments. Accordingly, employers and employees face issues similar to deferred compensation when determining the correct amount of nonresident withholding from accrued vacation pay.

In a 2012 decision, the Oregon Tax Court addressed withholding from accrued vacation payments in Ballard v. Dept of Revenue. The issue before the Oregon Tax Court in Ballard 2012 was "whether a lump sum payment, paid to a nonresident taxpayer while working in Oregon, for accrued and unused vacation time earned while working both within Oregon and in other states, is considered Oregon source income subject to tax by the state." Over the course of approximately twelve years of employment with the same employer, the taxpayer earned several hundred hours of accrued vacation pay from services performed in Oregon. When the taxpayer began working in Oregon, he carried over significantly more
hours of vacation time that he earned while working in other states. Upon his retirement, the taxpayer received a lump sum payment for accumulated vacation from which the employer withheld tax.

Similar to other states, Oregon taxes nonresident income “derived from or connected with sources in this state,” including nonresident income from a “business, trade, profession or occupation carried on in this state.” Based on this broad statutory authority, the Oregon Department of Revenue issued a regulation asserting that compensation for services includes vacation pay. The Oregon Tax Court observed that the relevant statutory provisions and Department regulations do not make a distinction between vacation days earned in other states and vacation days earned in Oregon.

Thus, because the taxpayer spent all of his working days in Oregon during the 2009 tax year, the Oregon Tax Court concluded that 100% of the income received should be sourced entirely to Oregon. However, in a subsequent decision issued in 2013, the Oregon Tax Court determined that, based on a review of the employer’s vacation policy, it was proper to refund an amount of Oregon tax based on accrued vacation hours earned out-of-state, according to an apportionment percentage of accrued vacation hours earned in Oregon.

Considerations and Recommendations

Employers with multistate business travelers face a daunting task if they seek some modicum of compliance with state withholding laws for their special payments. Indeed, states adopt various withholding thresholds and allocation methodologies, none of which may apply to deferred compensation and other special payments. It is therefore important for an employer to properly characterize the compensatory payment at issue and the services to which the payment is attributable.

Based on the above guidance, employers and/or employees may prevent considerable tax compliance issues by clearly explaining with specificity the reason (i.e., the services performed) for the payment and the place where such services are performed by the employee or former employee. Indeed, the “critical factor that determines the source of income from personal services is . . . the place where the services are actually performed.” For example, the taxpayer in DeGroat may have avoided payment of additional New York individual income tax if her former employer specified the location of the claims subject to the release of claims agreement and settlement payment made thereunder.

Including specifics as to the type and location of services performed is important, for example, where the agreement is based on forbearance of a future activity, such as filing suit or competing against one’s
former employer. Such specificity is equally important when allocating wages for services rendered partially within and without the taxing state, as was evident in Oregon's subsequent Ballard decision. Finally, it may be appropriate to draw analogies from existing guidance so long as the determinative factors (such as residency status) are similar, as recently suggested by the Virginia Department of Taxation. 73


2 The states that do not impose an individual income tax on wages include Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming.


4 "Residency" versus "source" is a threshold question for multistate withholding compliance. Employers should adopt policies to collect and retain reliable residency information from employees, not only policies related to nonresident withholding. Employers generally must conduct some due diligence in good faith of their employees' statements of residency, although states provide different levels of relief and/or liability for employers in this regard. For this reason, employers should adopt the aforementioned policies to receive hold harmless protection from a state, if available, where an employee incorrectly provides the employee's state of residence. While residency determinations and audits are certainly important, this article does not address heavily fact-intensive residency analyses adopted by the states.

5 See generally Hellerstein at ¶ 20.10.

6 E.g., Delaware Tax Ruling No. 71-3, June 14, 1971; O.C.G.A. § 48-7-100(10)(H); Indiana Information Bulletin No. IT28, May 1, 2012; Massachusetts DOR Directive No. 91-4, 11/1/1991; 17 N.C.A.C. § 6C.0107. States may require an employer to withhold tax from a resident's wages if the credit for taxes paid does not eliminate that resident's tax liability for his or her residence state. When the employee's state of residence imposes a higher withholding rate than the nonresident state where the employee
worked, some states, like New York and California, will require an employer to withhold the difference between the "residence" state tax withheld and the "work" state tax withheld. For example, the New York Department of Taxation and Finance explains, "[i]f the amount required to be withheld under the respective weekly wage bracket tables is $2.60 for New York State and $1.53 for the Commonwealth of Massachusetts, the amount of New York State personal income tax required to be deducted and withheld is $1.07." 20 N.Y.C.R.R. § 171.5(b), example 1. Likewise, the California Employment Development Department requires employers to "withhold the amount by which the California withholding amount exceeds the withholding amount for the other jurisdiction." Employment Development Dep't, California Employer's Guide 2012, Form DE 44 Rev. 41, Jan. 2015. Other states may not require an employer to withhold such excess residence state amount if the wages are "subject to" withholding in another state. Generally, states will not require withholding from a resident's wages if the amount withheld for the work state is equal or greater than the amount withheld for the residence state. See, e.g., 20 N.Y.C.R.R. § 171.5(b), ex. 2, 3; Employment Development Dep't, California Employer's Guide 2012, Form DE 44 Rev. 41, Jan. 2015.

7 A state that has entered into a reciprocity agreement has agreed that it will impose tax and withholding only on residents of the state and will not impose tax or withholding on residents of the other state(s) party to the agreement if, in many instances, the employee completes a form averring to the employee's residency status.

8 A primary consideration is whether there is an employee-employer relationship between the worker and the business. However, worker classification is beyond the scope of this article.

9 N.C.G.S. §§ 105-163.1(4), 105-163.2(a).

10 Cal. Unemp. Ins. Cd. § 13020; see also O.C.G.A. § 48-7-101(c) (requiring Georgia employers to withhold tax from employees' wages "computed in such manner as to result, so far as practicable, . . . an amount substantially equivalent to the income tax reasonably estimated to be due for the calendar year as a result of including the employee's wages received during the calendar year in the employee's Georgia adjusted gross income"), M.R.S. 36 § 5250(1) (requiring Maine employers to withhold tax from employee's wages during each calendar year in an amount "substantially equivalent" to the tax reasonably estimated to be due from the employee with respect to the amount of those wages included in the employee's adjusted gross income during that calendar year).

11 See, e.g., O.C.G.A. § 48-7-100(10) (defining "wages" as "all remuneration paid including, but not limited to, the cash value of all remuneration paid in any medium other than cash and shall be computed
without any deduction of any amounts withheld by the employer for any reason and regardless of the terminology which the employer or employees may apply to the remuneration,” subject to exceptions); Ala. Admin. Code § 810-3-70-.01(1)(a) (“wages” has “the same meaning as defined in the Internal Revenue Code, as amended from time to time”). In addition to conforming to the federal withholding tax base of “wages,” federal income tax concepts such as recognition may determine when a state requires an employer to withhold from employee wages. See, e.g., In the Matter of The Denial of Individual Income Tax Refund for the Taxable Year 1999 by the Secretary of Revenue of North Carolina v. Taxpayers, N.C. Dep't of Revenue, Dkt. 2004-200, Dec. 14, 2004 (explaining North Carolina's conformity to Section 83 of the Internal Revenue Code). Furthermore, many states use federal adjusted gross income as the starting point for calculating state taxable income, generally conform to the Internal Revenue Code either through “floating” or “static” conformity provisions, or adopt specific provisions of the Code that are relevant such as whether compensatory payments are “qualified” or “non-qualified.” See, e.g., La. R.S. §§ 47:290, 47:293(1); N.C.G.S. §§ 105-153.4(a), 105-228.90(b)(1b). See also the discussion of Georgia’s definition of “deferred compensation,” below.


13 See, e.g., Connecticut Announcement No. 2010(3), Jan. 1, 2010 (employers not required to withhold under Connecticut's "14-day rule," infra, must nonetheless report any such income as Connecticut source income on the employee’s W-2).


15 Id.


Cal Code Regs. 18 s. 18662-2, 18662-4(a)(2); Cal. FTB Pub. No. 1017.


O.C.G.A. § 48-7-100(10).

O.C.G.A. § 48-7-100(10)(K).

O.C.G.A. § 48-7-100(10)(K).

M.R.S. 36 §§ 5250(1) (requiring the amount withheld from the employee's wages during each calendar year must be "substantially equivalent" to the tax reasonably estimated to be due from the employee with respect to the amount of those wages included in the employee's adjusted gross income during that calendar year).

M.R.S. 36 §§ 5250(1), 5142(8-B).

Id., see also Code Me. R. § 803(4)(3)(A).


Presumably, tax agencies that do not apply their respective withholding thresholds to deferred compensation do so to preempt tax avoidance by deferring income earned for services performed in the state (and, hence, subject to state withholding) to a subsequent year in which the employee performed no services in the state. But not applying a withholding threshold in a reasonable manner can lead to a harsh result. From an employer's perspective, it may be unreasonably burdensome or impossible to keep two sets of records for ordinary wages and deferred compensation.


See, supra, Cal. Unemp. Ins. Cd. §13020; O.C.G.A. §48-7-101(c); M.R.S. 36 §§ 5250(1).

See Hellerstein at ¶ 20.07 and cases discussed therein.
35 N.Y. Tax Law § 631(g).


37 Id.

38 NYS Tax Appeals Tribunal, 823829, March 18, 2014.

39 See New York Technical Service Bureau Memorandum TSB-M-07(7)l, Oct. 4, 2007 (explaining the grant-to-vest allocation methodology applicable to various types of option income and, specifically, the election to use that methodology or other methodologies for the 2006 tax year at issue in Gleason).

40 496 NE2d 674 (1986) (establishing the proposition that a nonresident individual employed in New York State who received an incentive stock option (as used in Internal Revenue Code § 422), exercised the option, and subsequently sold the stock at a gain would be subject to New York individual income tax only on that portion of the gain that represented the difference between the option price and the fair market value of the stock at the time the option was exercised).

41 E.g., Conn. Agencies Regs. §§ 12-711(b)-16 (incentive stock options), 12-711(b)-17 (property transferred in connection with the performance of services), 12-711(b)-18 (NQSOs), and 12-711(b)-19 (nonqualified deferred compensation).


43 As described by the Ohio Department of Taxation, "[f]or purposes of determining the Ohio-related appreciation, the nonresident will treat as Ohio income the value of the unexercised stock option at the time the individual left Ohio minus the value of the unexercised stock option at the time the individual received the option. In those cases where an individual receives a stock option prior to either moving to or working in Ohio, then the Ohio-related appreciation will be based upon the value of the unexercised stock option when the individual leaves Ohio minus the value of the unexercised stock option at the time the individual first became a resident of Ohio or first began working in Ohio." Ohio Tax Info. Rel. No. IT 1996-01, May 1, 2007.

44 SBE Case No. 222814, Aug. 24, 2004 (not to be cited as precedent).

45 Id. (citing Appeal of Sam and Betty Spiegel, 86-SBE-121, June 10, 1986).

See also Appeal of Grubic, SBE, Case No. 380418, Dec. 16, 2008, (not to be cited as precedent) (options received as compensation for services performed in California and any income therefrom after exercise was properly sourced to and taxable by California even though the taxpayers retired to Florida at the time they exercised the options).

SBE, Case No. 527783, Jan. 14, 2013 (not to be cited as precedent).

California FTB Chief Counsel Ruling No. 2013-2, 07/31/2013; to the same effect, see California FTB Chief Counsel Ruling No. 2014-1, May 13, 2014.


O.C.G.A § 48-7-1(11)(E).

O.C.G.A § 48-7-1(11)(E)(i)(I), (II).

Ga. Comp. R. & Regs. §560-7-4-.05(3)(a).

Id.

See, e.g., O.C.G.A. § 48-7-101(f)(5) (authorizing the Commissioner of Revenue to "prescribe the manner and extent to which withholding tax shall apply to extra payments to employees for services rendered, including, but not limited to, bonuses, separation pay . . . and to authorize, under such conditions as the [C]ommissioner deems proper, an employer to compute the tax to be withheld from the payments so as to make adjustments to the annual wages which the employer may pay to the employee.")

Ohio BTA, Case No. 2010-1590, May 12, 2015. Ohio's municipal income tax reform legislation, effective for municipal income tax years beginning on and after January 1, 2016, continues to include nonqualified deferred compensation described in Internal Revenue Code § 3121(v)(2)(C), within taxable wages. See O.R.C. § 718.01(R), -(B)(2) (defining "qualifying wages" included in a nonresident's "income" if "earned or received by the nonresident for work done, services performed or rendered, or activities
conducted in the municipal corporation.

A municipal corporation may exempt such deferred compensation, however, if it adopts a resolution or ordinance doing so before January 1, 2016.


60 See, e.g., Conn. Agencies Regs. 12-711(b)-20(a) (providing that Connecticut adjusted gross income derived from or connected with sources within Connecticut includes income that is received by a nonresident individual from a covenant not to compete, to the extent that such income is attributable to refraining from carrying on a trade, business, profession or occupation in Connecticut); N.Y. Tax Law § 631(b)(1)(F) (providing “[New York source income includes] income received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, whether or not as an employee, including but not limited to, covenants not to compete and termination agreements. Income received by nonresidents related to a business, trade, profession or occupation previously carried on partly within and partly without the state shall be allocated in accordance with the provisions of subsection (c) of this section”); see also New York Technical Service Bureau Memorandum No. TSB-M-10(9)I, 08/31/2010 (requiring, “amounts an employer pays to an employee for cancellation of an employment contract and relinquishment of contract rights are wages subject to income tax withholding.”)


62 Va. Code § 58.1-461 (generally requiring Virginia employers to deduct and withhold from wages paid to their employees, for each payroll period during the calendar year, amounts that approximate the employee’s income tax liability to Virginia for the tax year).

63 Virginia Public Document Ruling No. 05-36, March 16, 2005; see also Virginia Public Document Ruling No. 10-37, April 8, 2010 (ruling that income received by a nonresident of Virginia for a promise not to compete is not considered income from Virginia sources and is not taxable by Virginia).

64 Id.


66 Id.


68 O.R.S. § 316.127(1)(a), -(2)(b).
Ballard v. Dep't of Revenue, Ore. Tax Ct., Dkt. TC 5136, June 20, 2013. The Ballard 2012 court rejected the taxpayer's argument that the lump sum payment should be excluded from Oregon source income because he earned the income wholly outside of the state. The court noted at least some of the carried-over vacation hours were the result of work in Oregon and the taxpayer continued to be eligible to use those hours in Oregon. Therefore, the compensation had some connection to the state. Importantly, the court also noted that the lump sum payment was "based on pay rate at time of retirement." Ballard (2012), at 5. While the taxpayer earned some of the carried-over vacation hours for work performed in other states, the court initially found more persuasive that the taxpayer recognized the income during the tax year at issue and did not exercise his right to that income "until he was working solely in Oregon." Id.

Appeal of Lyon, SBE Case No. 222814, Aug. 24, 2004 (not to be cited as precedent), (citing Appeal of Sam and Betty Spiegel, 86-SBE-121, June 10, 1986).