

# Human resources state tax issues

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**E**nsuring compliance with employment-related state tax laws is one of many important things that human resource (HR) professionals do.

It is common for businesses to have people who work somewhere other than where they live and work at multiple locations, often in multiple and different states and localities. Consequently, HR-type state tax issues come up from time to time – if not daily. Following are several common issues:

## Employee or independent contractor?

The question of whether a worker should be classified and treated as an employee or as an independent contractor is quite common – though the scale and scope of the issue varies from business to business. Some businesses make extensive use of independent contractors, *e.g.*, taxi services. Other businesses primarily use employees and selectively use independent contractors to obtain specialized services as needed or as required.

In an audit, administrative taxing agencies like the Internal Revenue Service or state departments of revenue do not generally challenge businesses' classification of workers as employees. Instead, their auditors focus on whether independent contractors should be classified as employees. This determination turns on the relationship between the company and each worker and requires an examination of: the

control the business exerts over the worker's behavior, *e.g.* instructions, training, etc.; the business' control over financial aspects of the worker's services, *e.g.*, risk of profit or loss, etc.; and, the type of relationship between the business and the worker, *e.g.*, whether it is governed by a contract (or not). IRS Publication 1779, Independent Contractor or Employee provides a general overview of factors the IRS considers to be important.

Worker classification issues can certainly arise, not only in federal employment tax audit, but also (as alluded to above) in state employment tax audits. To this point, 2012 Kentucky Senate Bill 77 would have, had it passed during the 2012 Regular Legislative Session, designated the Kentucky Department of Revenue as the determining authority on worker classification issues.

Another issue impacted by a worker's classification arises in the context of reciprocity agreements between states. For example, the Reciprocity Agreement between Kentucky and Indiana applies to

wages, but not to the earnings of an independent contractor. The Kentucky-Indiana Reciprocity Agreement authorizes a resident of Indiana working in Kentucky as an employee to pay tax on wages only to Indiana -- and not Kentucky. However, because this Agreement does not apply to independent contractors, an Indiana resident working as an independent contractor in Kentucky must pay tax on their income to both Kentucky and to Indiana (with a tax credit for Kentucky tax paid). Given the disparity of the top marginal individual income tax rates in Kentucky (6%) and Indiana (3.4%), this can have a significant impact.

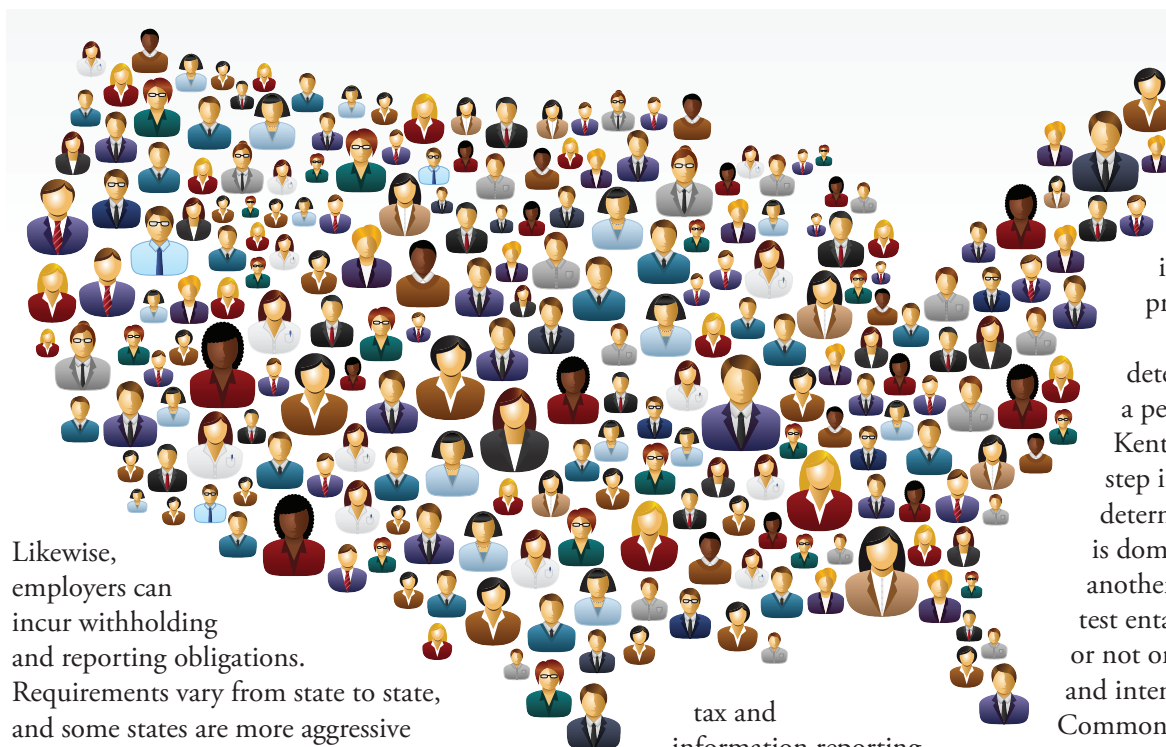
## Multi-state employees

Some employees perform all of their duties in one location. For example, factory workers work in a factory; hospital employees work in a hospital. There are many other examples in which workers perform virtually all of their job functions in one building. But, some employees move around when they work, sometimes performing their job functions in multiple states, for example, a sales representative.

An employee performing job duties in multiple states can potentially incur obligations to report and pay income taxes in states in which the employee derives income from performing their job duties, depending on the amount of time and work performed in the involved state.

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## Human resources continued



Likewise, employers can incur withholding and reporting obligations. Requirements vary from state to state, and some states are more aggressive than others at attempting to enforce their tax laws on non-residents and their employers, even when an employee spends only a relatively short period of time working in the state.

State reciprocity agreements often provide an answer to this issue but there are not reciprocity agreements between all states. Reciprocity agreements are the exception, not the rule.

The federal Mobile Workforce State Income Tax Simplification Act of 2012, if enacted, would provide a comprehensive solution to this problem by prohibiting an employee's wages from being subject to income tax by any state other than: [i] the state of the employee's residence [ii] and, a state in which the employee is present and performing employment duties for more than thirty days during a calendar year. Importantly for HR professionals, the Act would also exempt employers from withholding

tax and information reporting requirements for employees not subject to income tax. Until this Act or similar legislation is enacted, HR professionals must deal with a national patchwork of different and non-uniform rules for withholding tax on and reporting of wages.

### State of residence

Ordinarily, each employee tells their employer what their state of residence is. From time to time, given the importance of the state of residence to each employee's state tax obligations and to the employer for determining its obligation to withhold state income taxes, an HR professional may encounter questions regarding an employee's residency.

In many cases, it may often not be apparent to an HR professional that there is any issue with regard to the state of residence claimed by

an employee.

For example, an office location in Louisville, Kentucky can be expected to have employees who reside in Kentucky and in Indiana, given the proximity to Indiana.

In Kentucky, the determination of whether a person is a resident of Kentucky or not is two-step inquiry. First, one must determine whether the worker is domiciled in Kentucky or another state. This common law test entails determining whether or not one resides in Kentucky and intends to remain in the Commonwealth; it is a factually intensive inquiry especially when contacts with multiple taxing jurisdictions are involved. *See, Dept. of Revenue v. Slagel*, 253 S.W.3d 374 (Ky. App. 2008). The second statute-based inquiry turns on whether or not a person has an abode in Kentucky and also spends approximately half the year or more in the Commonwealth; if so, that person would be a resident of Kentucky by statute. When the facts are not straight forward and involve multiple states, residency can be a difficult issue.

### Potential for officer liability

Federal and state statutes that require employers to withhold taxes from their employees' wages and pay them over to the Internal Revenue Service and state departments of revenue often describe this obligation as one of trust. This can, depending on the statute, fall on an HR officer,

particularly one with responsibility for overseeing a business's payroll. Accordingly, it is important for HR professionals to ensure that income taxes that are withheld are remitted to the appropriate taxing jurisdictions. There are hefty civil and, in severe cases, criminal penalties that can apply. There are also exceptions.

## Localities

In Kentucky, there are 120 counties, cities within those counties, and multiple taxing jurisdictions within those counties as well. Many counties, cities and taxing districts

impose their own occupational license tax on the wages of employees working within their jurisdictional boundaries. For employers with multiple locations or employees moving from place to place within the Commonwealth, this can cause major compliance headaches. Fortunately, the Kentucky Society of CPAs maintains a comprehensive list available to its members on [kycpa.org](http://kycpa.org).

**"In order to cut costs, some of you will be relocated to the bottom of the ocean."** - Catbert: Evil Director of Human Resources (*Dilbert* by Scott Adams, Nov. 24, 2003)

Employees can be just about anywhere and so can state tax issues. When issues arise, address them on the front end – using an ounce (or so) of prevention; otherwise, they will often pop back up on the back end – requiring a pound (or so) of cure.

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