

New York State Audits

March 2, 2017



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Who is the Auditor?

- ▶ **Definition** – Individual truly unhappy with his/her life. Is happy when you are unhappy. Has **NO** sense of humor. Will fight you for every penny as if it was going into their own pocket. Is rarely in the office to answer your call. Will answer your question with a question. Is only responsive when you sign a waiver extending the statute of limitations.

New York employer audits are on the rise

Income tax withholding audits

The New York State Department of Taxation and Finance reports that withholding tax audit assessments in fiscal year 2014 reached \$33.2 million, increased to \$50.8 million in fiscal year 2015 and will exceed \$62 million in fiscal year 2016.

State Department of Labor audits

The New York State Department of Labor conducted over 7,500 audits in fiscal year 2014, reclassifying more than 58,000 workers from independent contractor to employee. In the same period, the Department identified underreported wages in excess of \$1.3 billion.

Federal Department of Labor audits

Through the federal Questionable Employment Tax Practices (QETP) initiative, New York and other states share their audit findings with the Internal Revenue Service (IRS) and US Department of Labor. QETP also provides that the IRS share information with states such as New York concerning nonemployee compensation filed by businesses on Forms 1099-MISC, a process that has resulted in state employment tax assessments of more than \$20 million.



New York State Department of Taxation and New York State Department of Labor Audits

- ▶ Withholding Tax Audits
 - ▶ 100+ employees and \$10 million wages
 - ▶ Subsidiary located in NYS
 - ▶ News article relating to a larger merger or acquisition
 - ▶ Re-audit – previously audited by NYS
- ▶ State Unemployment Audits
 - ▶ Large population of Form 1099 individuals
 - ▶ Form 1099 individual attempting to collect unemployment benefits

Business Profile

The auditor's pre-audit analysis will:

1. Determine how the business operates
2. Identify which business functions are carried on in NYS
3. Ascertain total number of workers employed within and outside of NYS
4. Investigate whether there where prior withholding, corporation or state unemployment tax audits
5. Question taxation on regular and supplemental wages
6. Tracking nonresident employees

Income tax withholding records

What is vital for an audit?

Auditor's Initial Document Request

▶ Withholding Audits

- ▶ Information Document Request
- ▶ Withholding Tax TAA Field Audit Questionnaire
- ▶ Distribution of Earnings Codes (DOE)
- ▶ Power of Attorney
- ▶ Payroll feed as of 12/31/20XX for all years under audit
- ▶ Form DTF-76, *General Business Corporation Computer Audit Questionnaire*
- ▶ Form AU-377.14, *Test Period Audit Method Election Agreement*



IDR



Sample TAA
Questionnaire



NYS POA



Form DTF-76



Form AU-377.14

▶ State Unemployment Insurance Audits

- ▶ Information Request
- ▶ Power of Attorney

New York withholding audit

Sample information document request (IDR) items

1

Mergers

Provide a description of any mergers, acquisitions and/or sales of any affiliated entities.

2

Work travel

Describe the system of tracking the travel of highly compensated employees based outside of New York.

3

Work location

Provide any magnetic swipe or security card system records for New York locations.

4

Allowances

Describe the process for collecting withholding certificates from employees (e.g., Form W-4, the NYS Form IT-2104).

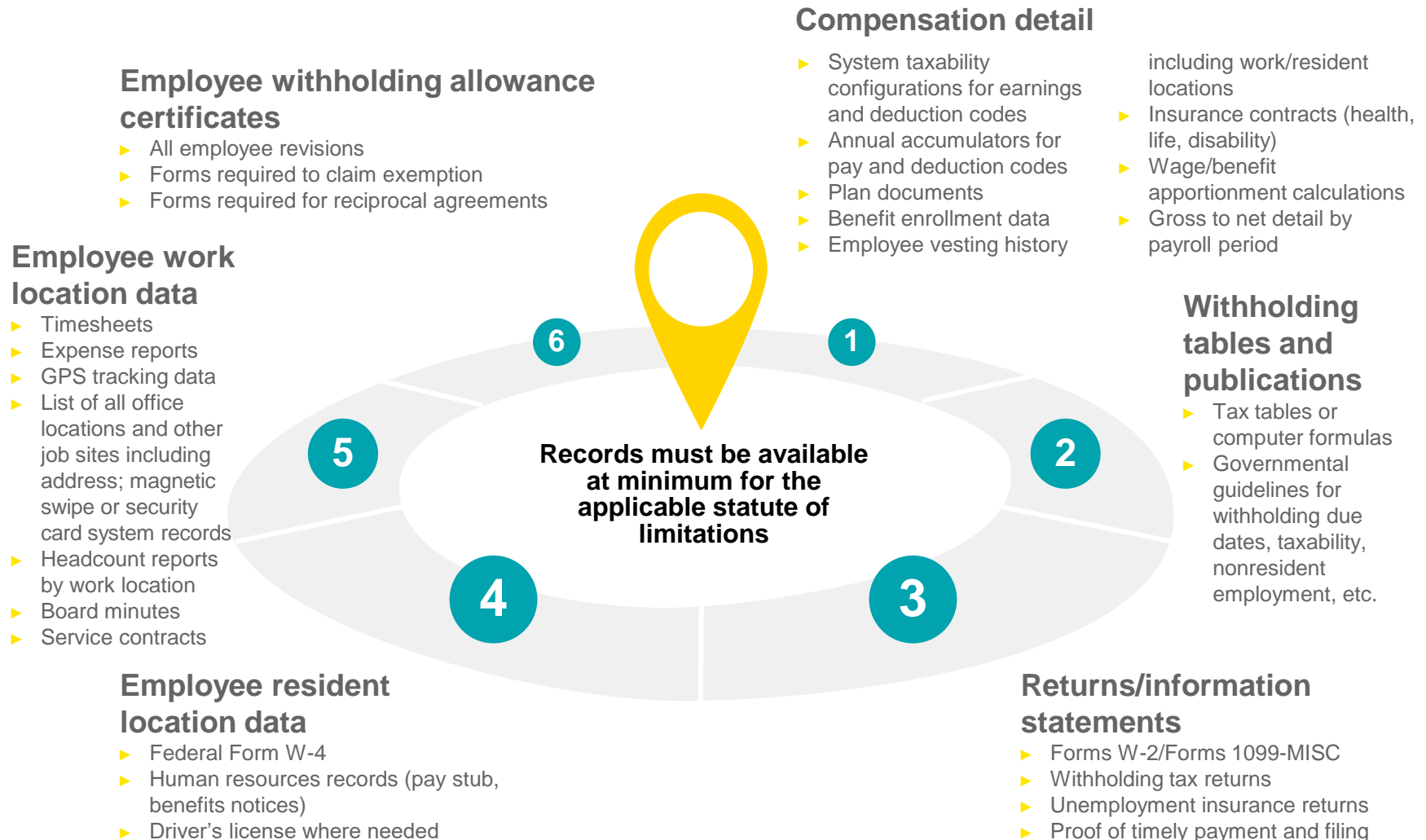
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Nonresidents

Provide a list of corporate apartments or houses located in New York.

Income tax withholding records

What is vital to a tax audit?



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Florida resident working in New York

Understanding complexity of nonresident income tax

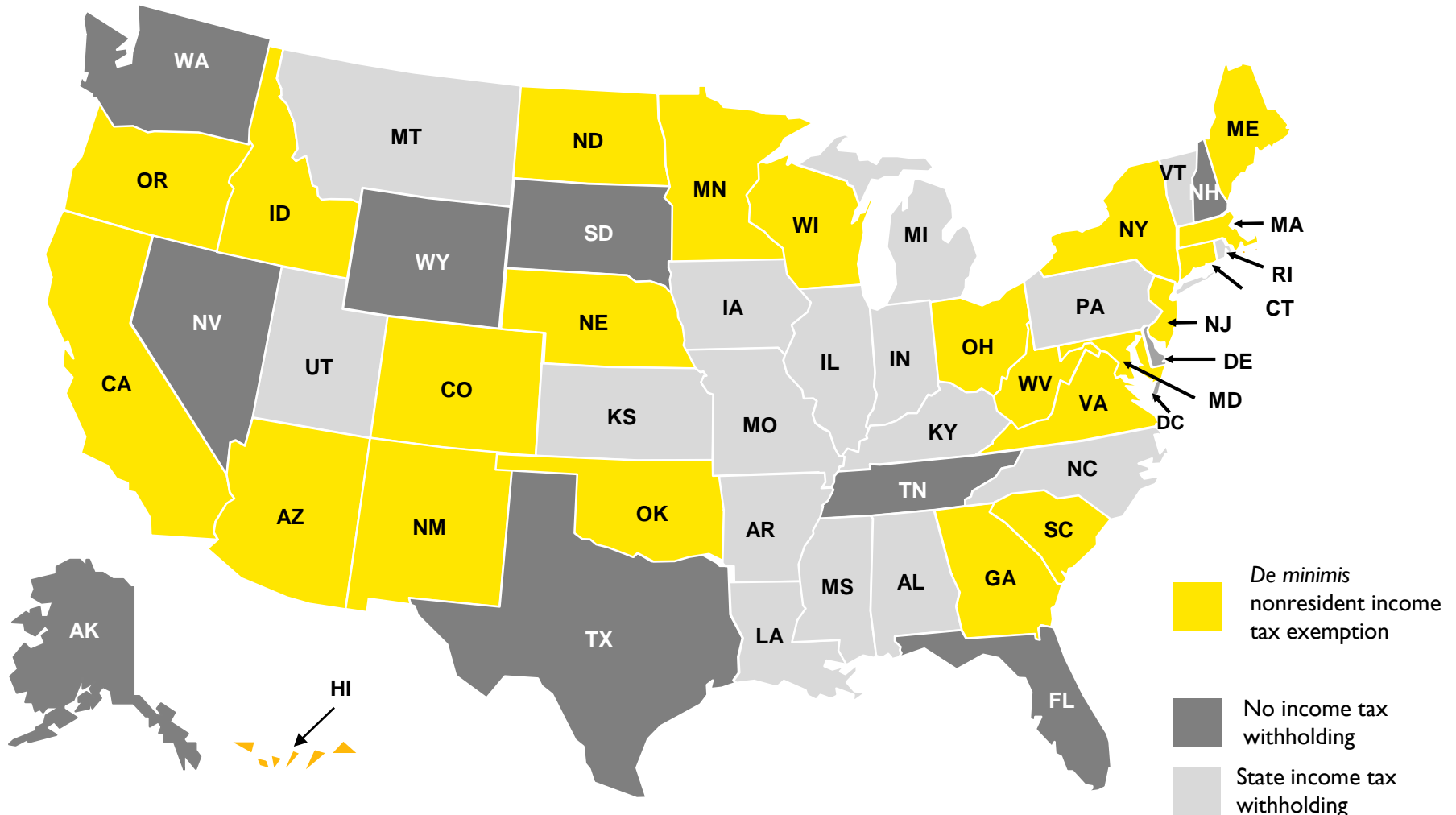
Scenario 1



- ▶ **Florida state income tax.** There is no personal income tax in Florida, therefore, resident state income tax does not apply
- ▶ **New York nonresident income tax.** New York requires state income tax withholding if an employee works more within the state for more than 14 days
- ▶ **New City nonresident income tax.** New York City income tax does not apply to nonresidents
- ▶ **New York Form W-2 reporting.** New York requires that Box 16 equal Box 1. For this reason, the employer should provide information to the employee concerning the total days and wages earned within New York
- ▶ **Florida Form W-2 reporting.** Box 16 reporting is not required for Florida wages

Nonresident income tax for short assignments

Only 23 states have an exemption based on days or earnings



Mobile workforce income tax

Federal proposed legislation

Which states have the most to gain from nonresident income tax enforcement?

A state stands to profit from its nonresident income tax collections when:

- 1** It has a high volume of nonresident traffic (e.g., California and New York).
- 2** The business traveler pays no income tax in the resident location (e.g., Texas and Florida)
- 3** The nonresident income tax rate is higher than the resident tax, which is likely in states with the highest personal income tax rates (e.g., California, New York, Minnesota and Oregon).

Mobile Workforce State Income Tax Simplification Act (H.R.2315/S.386)

- ▶ First introduced in 2009
- ▶ Passed House in 2012, but not the Senate
- ▶ Currently opposed by the Federation of Tax Administrators and the National Governors Association
- ▶ Also opposed by states that benefit the most from nonresident income tax revenues
- ▶ Currently supported by the American Institute of Certified Public Accountants and the American Payroll Association
- ▶ Notably, the proposed legislation would prohibit a state from imposing an income tax on nonresident individuals who work within the nonresident state for 30 or fewer days
 - ▶ The bill does not address the tax treatment of equity or other trailing compensation

Telecommuter considerations

The home office could be a local business office



- ▶ If employees regularly work from home, the home office could be treated as a work location of the employer in many states (and localities)
- ▶ If the home office is deemed an employer work location, the business can be subject to income tax withholding, unemployment insurance and other business taxes
- ▶ In a New Jersey case, it was determined that a foreign corporation with a principal place of business in Maryland was subject to New Jersey's corporate income tax requirements because one of its employees was allowed to work on a full-time basis from her New Jersey home office (*Telebright Corporation v. Director, N.J. Super. Ct. App. Div., Dkt. No. A-5096-09T2, 03/02/2012*)

Telecommuter considerations

Nonresident income tax may apply in the headquarters' state

Double taxation under “convenience of the employer” rule

- ▶ Some states (e.g., New York) take the position that 100% of the wages paid to a nonresident are subject to New York income tax if the employee is working out of state for the employee's own convenience (and they spend at least some time in the state during the year)
- ▶ The rule applies when an employee receives direction and control from a New York location
- ▶ To argue that work location is for the employer's convenience, there must be a direct business benefit in having the employee work outside of New York
- ▶ The rule can result in double taxation (e.g., tax in both the resident state and New York)
- ▶ The US Supreme Court declined to hear a challenge concerning the constitutionality of this law ([Zelinsky v. Tax Appeals Tribunal](#))



State income tax withholding audit flags

What state income tax withholding auditors may consider

Top
15

State income tax withholding audit flags

- 1 The state(s) where employees perform services is actively engaged in withholding tax audits.
- 2 Vehicles or equipment that prominently display the company's name and/or logo are frequently present in the jurisdiction.
- 3 Officers and highly-paid employees frequently perform services in a particular state, and/or their presence in the state is easily documented or otherwise well-known. For example, public records reflect an upcoming acquisition, purchase or stockholder meeting.
- 4 Sales and use taxes are paid to the state but not income tax withholding.
- 5 Wages are reported on Form W-2 to the state, but no local wages are reported.
- 6 Expense reports show reimbursement for travel to other states and localities.
- 7 Accounts payable records show travel, relocation or other "out-of-state" related costs paid on behalf of employees.
- 8 A parent operates a subsidiary in one or more states other than the state of the parent company.
- 9 The company holds a corporate lease or otherwise owns property in the jurisdiction for use by its employees.
- 10 Employees own or lease residential property, hold driver's licenses or are registered to vote in a state other than the resident state shown on the Form W-2 or Form W-4.
- 11 Unemployment insurance is paid to the state but not income tax withholding.
- 12 Wage and tax adjustments were filed with one taxing jurisdiction and not another. Keep in mind that the IRS has information sharing agreements with states departments of revenue and labor.
- 13 Accounting records reflect a tax reserve for contingent liabilities connected with underreported wages and related income taxes.
- 14 The company is under contract with the state or municipality to provide goods or services.
- 15 Independent contractors are substantially used in a state, irrespective of whether the company is deemed to be doing business in that jurisdiction.

New York withholding tax audit insights

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New York withholding audit

Select audit samples

Nonresident review

- ▶ All employees with no nexus to New York state/city at the end of the year with federal wages greater than \$20,000 and New York state wages greater than \$0.

No reported wages

- ▶ All employees with no nexus to New York state, no New York state wages, and no New York state income tax withholding.

Telecommuters

- ▶ All employees with a New York work state code or New York physical work location code but no New York state address (i.e., employees who work in New York but do not live in New York).

Telecommuters

- ▶ All employees with no nexus to New York state who have an indicator that they telecommute.

Resident income tax

- ▶ All employees with a New York state/city ZIP code, New York state address or New York resident state code and zero New York state/city income tax withholding.

US outbound

- ▶ All employees who typically are US citizens and who are working in another country per the employer's records.

New York withholding audit

Select audit samples (continued)

Worker classification

- ▶ All employees with a New York work state code, work location code, or address who received both a Form 1099-MISC and a Form W-2 in the same year.

Incorrect withholding

- ▶ Employees with New York income tax withholding greater than zero and have a New York work state code, resident state code, physical work location code, or address and have little income tax withheld.

NYC withholding

- ▶ Employees with New York City withholding greater than zero, a New York City ZIP code and New York City withholding of less than 2% of taxable federal wages.

Worker classification

- ▶ All employees with a Social Security Number that matches a Social Security Number included in the New York state wage reporting database in at least one of the prior five years.

No withholding

- ▶ All employees with a New York state/city ZIP code, New York state address or New York resident state code and zero New York state/city income tax withholding.

Reconciliation

- ▶ Wages reported to New York per Forms W-2 does not agree to federal Form 940 or 941 (taking into account wages paid in other states).

Auditor Generated Reports

- ▶ New York State Department of Taxation
 - ▶ **Withholding Tax Audits (see attachment listing all auditor tests)**
 - ▶ Highly compensated non-resident employees (Report 3-2)
 - ▶ Focus on taxation of supplemental wages (Report 3-3)
 - ▶ Residency (NYC/Yonkers) (Report 8 and 9)
 - ▶ Expat employees (Report 14-T)

- ▶ New York State Department of Labor
 - ▶ **State Unemployment Insurance Audits**
 - ▶ Focus on worker classification
 - ▶ Three-part test
 - ▶ Company profile
 - ▶ Payroll test
 - ▶ Worker classification (1099) test

Report 3-2

- ▶ Non-residents travelling into New York
 - ▶ No prior NY connection
 - ▶ Federal wages of \$500,00 or more
- ▶ 14 Day Rule
- ▶ What is the auditor looking for?
 - ▶ Expense reports for sample population
 - ▶ Concur Report
 - ▶ Receipts, travel Itineraries

Report 3-3 All employees with a SSN which match a SSN included in the NYS Wage Reporting database in at least one of the prior 5 years.

- ▶ Supplemental Income

- ▶ Bonus
- ▶ Equity events
 - ▶ RSUs
 - ▶ Dividends

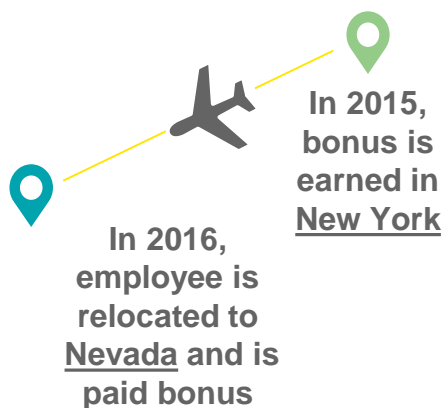
- ▶ What is the auditor looking for?

- ▶ Work history (look back period is 5 years from the test year)
- ▶ IT-2104.1
- ▶ Equity (RSU) vesting schedule

Trailing compensation

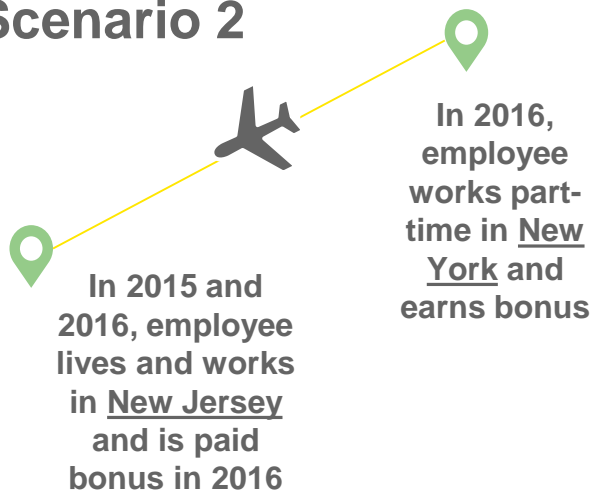
Sourcing delayed wage payments to the jurisdiction earned

Scenario 1



- ▶ In many US states and localities, lump sum payments such as accrued paid time off, severance, equity compensation and nonqualified deferred compensation must be sourced to the jurisdiction(s) where the compensation was earned for income tax withholding purposes

Scenario 2



- ▶ For US state income tax purposes, an exception applies to qualified retirement and to top heavy plans (Supplemental Executive Retirement Plan (SERP) or nonqualified deferred compensation) that are paid in substantially equal periodic payments over a period of not less than 10 years (*P.L. 104-95*)

Report 8 and 9

- ▶ Residence Tax
 - ▶ Report 8 – NYC (5 Boroughs)
 - ▶ Report 9 – Yonkers
 - ▶ Zero NYC/Yonkers withholding
 - ▶ You either live there or you don't
- ▶ What is the auditor looking for?
 - ▶ Resident address history screen shots
- ▶ NYS Jurisdiction/Rate Lookup By Address
 - ▶ Screen shot can be given to the auditor

Report 14-T

- ▶ Expat employees
 - ▶ Typically US citizens
 - ▶ Traveling abroad (UK, Hong Kong, Germany, etc.)
 - ▶ Work assignment for a fixed period of time
 - ▶ Typically 2 to 3 years

- ▶ What is the auditor looking for?
 - ▶ Assignment letters
 - ▶ Executed Form 673, *Statement for Claiming Exemption from WH*
 - ▶ Foreign paystubs
 - ▶ Travel calendar

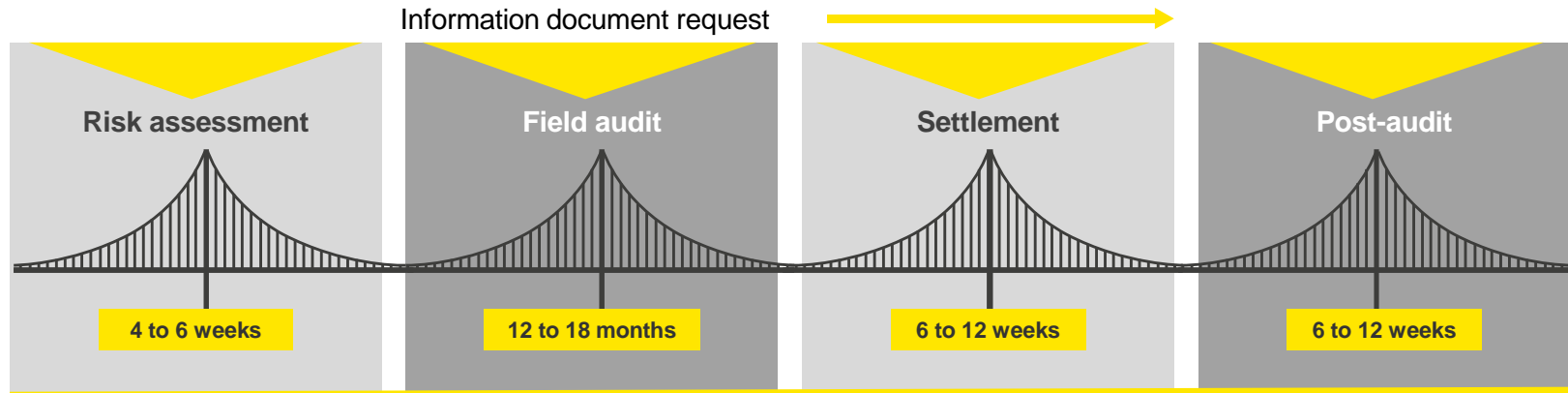
Audit defense process

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New York withholding audit

Audit defense life cycle



- Review company policy and procedures
- Identify information sources; confirm completeness of data
- Understand and document data anomalies
- Provide summary of findings

- Prepare responsive materials to the IDR, including preparation of electronic data files; gap mitigation; footnote exceptions; and document assessments that should not apply
- Participate in meetings with agency representatives

- Seek executive waivers
- Review penalty assessment accuracy
- Discuss audit terms with agency representatives
- Review the final audit assessment
- Complete audit closing steps, including preparation of amended employer returns
- Prepare and deliver employee communications and assist with tax return preparation
- Develop steps for, and assist with, ongoing monitoring

- Identify policy changes and revisions
- Review and document updates to procedures
- Prepare process statement for ongoing executive governance
- Perform a regular compliance review
- Conduct annual review of tax and reporting setups for earnings and deduction codes

Questions



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