



New York income tax withholding audits

What businesses need to know



Building a better
working world

For more information on
multistate income tax
withholding and audit risks,
visit our website:

ey.com/us/getonboard

#EYGetOnBoard



contents

Foreword	04
New York income tax withholding audits: what businesses need to know	07
New York state income tax withholding requirements	09
Teleworkers and the 'convenience of the employer' rule	09
Business travelers	09
New York's income tax withholding audit process	10
The information document request	10
Audit tests	10
1. Multistate nonresident withholding for regular wages	12
2. Trailing compensation	12
3. Inpatriate/expatriate work assignments	13
4. Income tax withholding tables and withholding allowance certificates	13
Measuring income tax withholding audit risk	14
What can businesses do?	16

You can read this report online at ey.com/us/getonboard.

Foreword

Ernst & Young LLP's employment tax and risk controversy professionals have observed a consistent increase in income tax withholding audits initiated by the New York State Department of Taxation and Finance. Currently, specific industry sectors appear to be the target, in particular financial services, pharmaceuticals, and media and entertainment. Over the last three fiscal years, audit assessments have increased from \$33.2 million in fiscal year 2014 to in excess of \$62 million in fiscal year 2016.

The Department has had years to perfect its techniques, so these audits leave no stone unturned in identifying anomalies that might lead to a hefty assessment. Responding to the Department's information document request (IDR) can be daunting, and for the inexperienced, avoiding a costly closing agreement is improbable.

To help businesses understand and mitigate their risk, Ernst & Young LLP has prepared this comprehensive special report, which examines the New York income tax withholding audit process, including its key areas of focus and compliance gaps where assessments are most prevalent.

This report is a must-read for executives and their delegates responsible for tax compliance, governance and risk assessment.

Sincerely,



Richard Ferrari
Partner
Ernst & Young LLP



Meet the authors



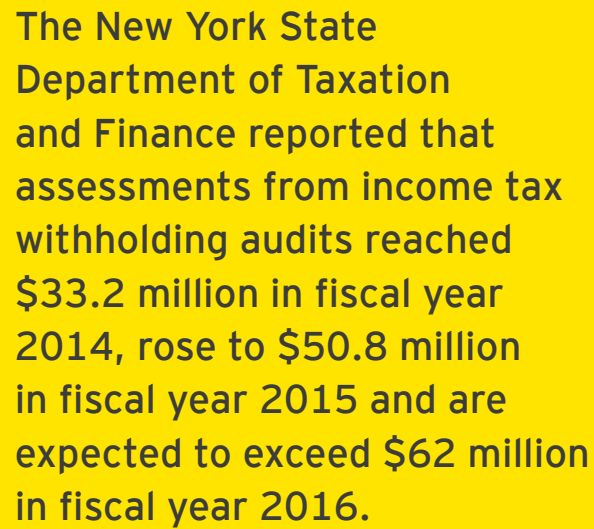
Richard Ferrari
Ernst & Young LLP
Partner
Indirect Tax
+1 212 773 5714
richard.ferrari@ey.com



Peter Berard
Ernst & Young LLP
Senior Manager
Employment Tax Advisory
+1 212 773 4084
peter.berard@ey.com



Francis Cannataro
Ernst & Young LLP
Staff/Assistant
Employment Tax Advisory
+1 212 773 4614
francis.cannataro@ey.com



The New York State Department of Taxation and Finance reported that assessments from income tax withholding audits reached \$33.2 million in fiscal year 2014, rose to \$50.8 million in fiscal year 2015 and are expected to exceed \$62 million in fiscal year 2016.

New York income tax withholding audits: what businesses need to know

New York continues to serve as a global capital for finance, innovation and headquarters for multinational corporations. Accordingly, it is the beneficiary of extensive executive business travel. New York also leads the country in its pursuit of withholding tax audit examinations, holding employers responsible to withhold, at source, income taxes on earnings associated with services performed in the state.

New York income tax withholding audits are nothing new. In fact, in 2004, the New York State Department of Taxation and Finance published [Withholding Tax Field Audit Guidelines](#) to streamline and standardize the audit examination process for its employment tax auditors. These guidelines are lengthy and specific, providing detailed instructions for various procedural aspects of an income tax withholding audit.

What is new about New York's income tax withholding audits is the increase in both scope and assessments over the last three years. The Department reported that assessments from income tax withholding audits reached \$33.2 million in fiscal year 2014, rose to \$50.8 million in fiscal year 2015 and are expected to exceed \$62 million in fiscal year 2016.

In this same three-year time frame, Ernst & Young LLP's audit defense professionals noticed heightened focus by the Department on the financial services sector, as well as other key industries, such as pharmaceuticals and media and entertainment.

Despite the frequency with which the Department initiates examinations and the volume of current audits, nothing indicates it will turn its attention away from pursuing other industry sectors.

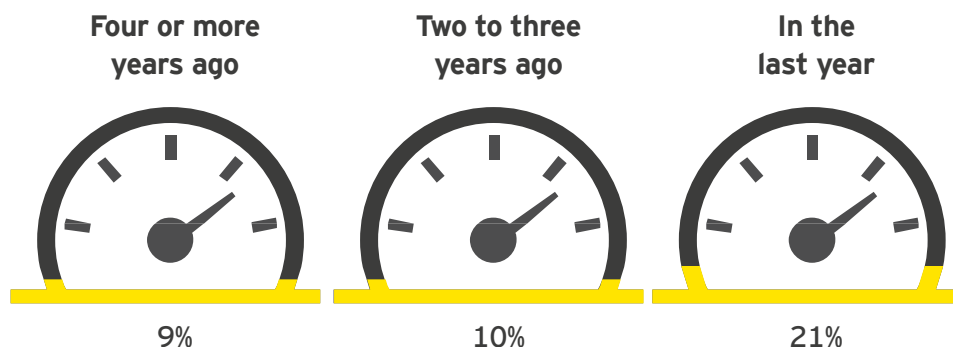
Ernst & Young LLP's audit defense professionals have additionally observed that employers already the subject of a New York income tax withholding audit are just as susceptible to subsequent audit selection as other businesses.


Considering the revenue these audit examinations continue to generate, there is little to suggest that the Department will soften its posture, and the current audit trends will likely continue into the foreseeable future.

Employers are no longer asking whether they should comply with New York state withholding tax guidelines. Rather, they are seeking support to bring their policies and procedures into compliance with New York's complex income tax withholding rules.

When is the last time the business was subject to a state income tax withholding audit?

2015 Bloomberg BNA and Ernst & Young LLP multistate payroll tax compliance survey





New York's convenience of the employer rule expands the reach of the income tax withholding requirement much further than some employers realize.

New York state income tax withholding requirements

New York's withholding tax audit process is supported by its laws, regulations, technical documents,¹ audit guidelines and historical audit precedents. In particular, the audit is primarily concerned with an employer's obligation to withhold New York state (and local) income taxes owed on wages sourced to the state.

Generally, New York tax law requires employers maintaining an office or transacting business within the state to deduct and withhold New York personal income tax from taxable wages paid to a resident or nonresident individual.² Specifically, employers must withhold New York income tax from all wages paid to residents, regardless of where they perform their services. However, for nonresidents, only wages paid for services performed within the state are subject to income tax withholding. In this context, New York wages subject to income tax withholding are those wages subject to federal income tax withholding.³ As a result, an employer must withhold New York state tax on all taxable compensation, including regular wages, trailing compensation (e.g., stock options, restricted stock and deferred compensation), bonuses and severance payments.

Employees may also be subject to New York City and Yonkers income tax withholding, and compliance with these requirements is also reviewed in a New York state withholding tax audit.

Teleworkers and the 'convenience of the employer' rule

Although nonresidents are typically taxed only on wages earned from services performed within the state, some exceptions apply. Of significant note, New York is one of the few states that apply the "convenience of the employer" rule in determining when an out-of-state teleworker is subject to New York income tax. Under this rule, nonresidents assigned to a primary work location within the state must have 100% of their wages sourced to New York if their services are rendered outside of the state for the employee's convenience rather than for the necessity of the employer and if the employee performs some amount of services within New York. An exception applies for work performed at a bona fide employer office outside of New York, but what constitutes a bona fide employer office is subject to narrow interpretation. New York's convenience of the employer rule expands the reach of the income tax withholding requirement much further than some employers realize.

Business travelers

Business travelers remain the key focus of the New York income tax withholding audit. Most audit assessments arise from errors in withholding, remitting and reporting the correct tax from wages paid to nonresident employees who are not primarily assigned to a New York office. The rigidity of some payroll systems adds to compliance difficulties for a number of employers left with inadequate technology to track multistate travel or withhold tax from wages and report such withholding to multiple states.

¹ The Department issues a range of informational guidance, including advisory opinions, technical memorandums and tax bulletins. Although the material is accurate on the date when a publication is issued, any subsequent changes in laws or regulations, judicial decisions or changes in Department policies could affect the validity of the information presented in such guidance.

² New York Tax Law §675.

³ 20 NYCRR §171.3(a)(1); IRC §3401(a).

New York's income tax withholding audit process

The typical New York income tax withholding audit is initiated by mailing the employer a formal audit notification letter that identifies the tax periods under examination and the information required for testing and review.

The information document request

The Information Document Request (IDR) generally includes a demand to review books and records, a power of attorney form,⁴ and a questionnaire tailored to identify an employer's landscape, develop an audit plan, and spot potential gaps in an employer's withholding process, controls and compliance.

As part of the IDR, the Department will require an employer to provide, for the calendar years under examination, an electronic payroll data file detailing, among other items, the domestic wages paid to employees across all US states and the taxes withheld. The Department also requests other records, such as business traveler policies and travel expense reimbursement records. These requests are essential to achieving the Department's aim of accurately determining the identity and frequency of employees traveling to the state throughout the audit period.

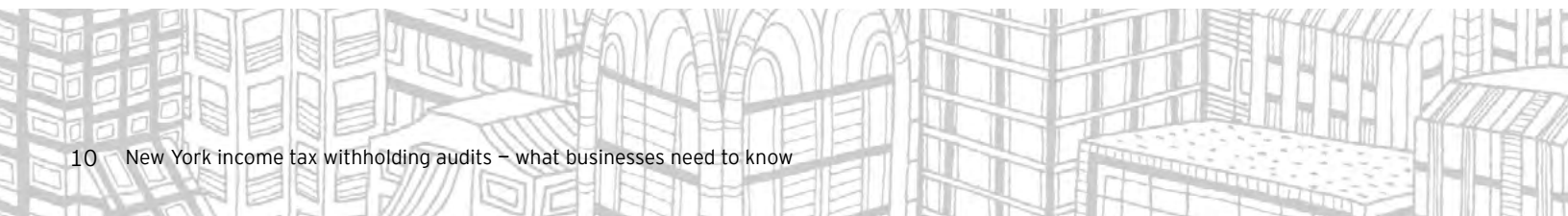
Audit tests

In the course of the audit, examiners are instructed to look at key areas where an employer may be noncompliant. The Department's [Withholding Tax Field Audit Guidelines](#) prescribe approximately 20 tests, or "reports," of potential compliance issues.

For instance, "Report 7" looks at all employees with a New York ZIP code, address or resident state code and zero New York state income tax withholding. The existence of this scenario could indicate the employer failed to withhold income tax on New York taxable wages. "Report 20-2" examines Form 1099-MISC recipients who were not employees in the current year but were classified by the employer as employees in at least one of the prior five years. This report assists the examiner in identifying instances where employees may have been incorrectly classified as independent contractors.

As these examples illustrate, each of the Department's audit reports is narrowly focused. But, in the aggregate, they serve its broader purpose: namely, whether the employer is generally compliant with the many regulations governing the withholding and payment of New York income tax and the filing of employer tax returns.

⁴ Because of the extensive audit procedures and potential consequences of a negative audit assessment, the Department provides the employer with a power of attorney so the taxpayer can appoint a qualified representative to discuss the case.



Extract of New York information document request and test scenarios

Test samples from payroll records provided

- ▶ 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.
- ▶ All employees with no nexus to New York state, no New York state wages, and no New York state income tax withholding. This report is sorted by the taxable federal wage amount and includes employees having taxable federal wage amounts over \$500,000.
- ▶ 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.
- ▶ All employees with no nexus to New York state who have an indicator that they telecommute.
- ▶ 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.
- ▶ All employees with a New York work state code or New York physical work location code but no New York state income tax withholding, no New York ZIP code, no New York resident state code and no New York state address (i.e., employees who work in New York but do not live in New York).
- ▶ All employees who typically are US citizens and who are working in another country per the employer's electronic data.
- ▶ All employees with a New York work state code, New York resident state code, New York work location code, New York state address or New York ZIP code who received both a Form 1099-MISC and a Form W-2 in the same year.
- ▶ Employees with New York state income tax withholding greater than zero and have a New York work state code, New York resident state code, New York physical work location code, New York address state or New York ZIP code and have combined state income tax withholding of less than 4% of taxable federal wages (i.e., employees who live and/or work in New York state and who have low income tax withholding).
- ▶ Employees with New York City withholding greater than zero and having a New York City ZIP code and New York City withholding of less than 2% of taxable federal wages.

Worker misclassification: Forms 1099

- ▶ All Form 1099-MISC recipients 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. These workers are not employees in the current year but were classified by the employer as employees in at least one of the prior five years.
- ▶ An exact copy of the 1099 Miscellaneous File that was filed electronically with the IRS.
- ▶ An extract of the employer's payroll information from electronic or third-party payroll systems.

Metropolitan Commuter Transportation Mobility Tax

- ▶ Estimate of payroll expense for covered employees for Metropolitan Commuter Transportation Mobility Tax.

Compensation and benefits

- ▶ Types of compensation paid during the audit years for prior services performed in the state (e.g., stock options, bonuses, severance pay).
- ▶ A copy of any employee handbook and/or "perk book."

Nonresident income tax withholding

- ▶ Description of any mergers, acquisitions and/or sales of any affiliated entities.
- ▶ Description of tracking system for travel of highly compensated employees based outside of New York.
- ▶ Magnetic swipe or security card system records for New York locations.
- ▶ NYS Form IT-2104.1 process.
- ▶ List of corporate apartments or houses located in New York.

Businesses selected for a New York income tax withholding audit can expect to receive an information document request (IDR), resulting in some of the tests shown here.



Employers sometimes overlook that, in general, New York income tax withholding is owed on all trailing compensation earned in the state without concern to the employee's work location or residence later when it is paid.

These are areas of primary attention in an income tax withholding examination:

1. Multistate nonresident withholding for regular wages

Employers based outside of New York may be unaware of their New York income tax withholding obligation. New York law mandates that employers withhold income tax from all nonresident employee wages earned in the state.⁵

Under this mandate, employers are responsible for accurately monitoring when employees travel to New York and for ascertaining the correct income tax withholding on those wages. Businesses employing individuals who travel frequently to New York for business are most at risk of audit findings. This is particularly true for business travelers who are high-wage earners because significant income tax withholding liability can accumulate quickly, even if the employee doesn't spend significant time in the state.

Many employers and practitioners are familiar with New York's 14-day de minimis withholding threshold, which states that, if a nonresident employee is not reasonably expected to surpass 14 days of service in the state in a given calendar year, the employer is not required to withhold New York income tax. While the Department will not penalize an employer for failing to withhold tax on wages in this case, the obligation to report an employee's wages in Form W-2, box 16, continues to apply, and penalties can be assessed for failure to comply. Further, this relief from income tax withholding is not available to employers that could have reasonably expected the employee to work in New York for more than 14 days in a calendar year.⁶

The Department makes a substantial effort to ascertain whether an employer allocated and withheld the appropriate income tax withholding on the wages of its nonresident employees.

2. Trailing compensation

Payments to employees of stock options, deferred compensation, and other income that is earned and paid over more than one year are subject to considerable scrutiny by audit examiners. Wages resulting from the payment of trailing compensation can be material, and the rules governing taxability are complex.

Employers are obligated to withhold New York income tax on the portion of trailing compensation considered New York source income. The time frame an employer must use to allocate this income is distinct. No longer is it simply the time spent in New York within a single year. Rather, an employer must calculate the total time an employee performed services in New York during the period the trailing compensation was earned.

With regard to trailing compensation, the 14-day exception does not apply. An employer is obligated to withhold New York income tax starting from the first day the trailing compensation is earned in the state.⁷

The resulting demands on the employer to meet its income tax withholding obligations on trailing compensation are great. Employee work and travel locations must be tracked and archived for as long as they are relevant to the employee's compensation. Employers must also understand the nuance between various trailing compensation payments (e.g., restricted stock units, restricted stock awards and non-statutory stock options). The Department prescribes rules for allocating each type of equity payment to the state and the time period in which the compensation is considered earned (i.e., the allocation period). Therefore, an employer must comply independently with each rule governing a specific compensation and cannot assume that each type is apportioned to New York in the same manner.

Employers sometimes overlook that, in general, New York income tax withholding is owed on all trailing compensation earned in the state without concern to the employee's work location or residence years later when it is paid. Consequently, they may be unprepared to comply with these requirements and, as a result, are left vulnerable to substantial consequences, especially if the oversight is discovered during a New York income tax withholding audit.

⁵ 20 New York Codes, Rules and Regulations (NYCRR) §171.6(a).

⁶ Technical Memorandum, TSB-M-12(5); *Withholding Tax Field Audit Guidelines* (rev. April 5, 2005).

⁷ Id.

Employers are ultimately accountable for any withholding tax liability as a result of failing to retain the appropriate withholding allowance certificates (or their electronic equivalents) and for failing to file copies of those wherein the employee requested more than 14 withholding allowances.

3. Inpatriate/expatriate work assignments

Employers should be cognizant of the Department's vigilant focus on the proper withholding and reporting of wages paid pursuant to a New York work assignment. Typically, New York audit examiners identify employees on a work assignment in New York based on employee addresses and on discrepancies in the wages reported to the Department and the New York income tax withheld on those wages.

For instance, the Department closely examines whether an employer properly complied with the "accrual rule" for employees leaving or entering the state on a work assignment.⁸ Application of the rule depends on the type of compensation and the period it is earned, a fact that increases the complexity of compliance.

Without maintaining a substantive policy preserving adequate documentation of the employer's withholding procedure, an employer faces significant risk of audit assessments. For example, an employee's assignment letter or contract and [Form IT-2104.1, New York State, City of New York, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax](#), delineate the time frame an employee performs work in New York and demonstrate an employee's good-faith estimate of work time within the state and the resulting income tax withholding required on those earnings. Documents such as these can prove invaluable to employers in overcoming their burden to defend income tax withholding calculations during an audit. The employer will also be required to show a similar good-faith effort in confirming that employee estimates of New York work time were reasonable based on the facts and circumstances.

4. Income tax withholding tables and withholding allowance certificates

Another area of frequent emphasis by the Department is ascertaining whether an employer utilized correct New York income tax withholding tables for a given time period. Withholding tables are generally reissued at the start of each year (but have been revised at other times). Simple withholding errors are common and can occur, for instance, when employees are paid supplemental wages, such as bonuses and equity compensation.

Employers must be able to substantiate income tax withholding calculations with information contained in employees' New York withholding allowance certificates. For instance, the employee provides the marital status and personal exemptions for New York income tax withholding purposes on [Form IT-2104, Employee's Withholding Allowance Certificate](#), and [Form IT-2104-E, Certificate of Exemption from Withholding](#), to claim exemption from New York income tax withholding. Failure to locate these documents (or an electronic version) could result in an assessment for withholding shortages.⁹

Frequently overlooked is the employer's obligation to file certain withholding allowances with the Department. Specifically, if an employee elects more than 14 withholding allowances, the employer must send a copy of the paper form to the Department for review and approval and must retain proof of the mailing. Circumstances triggering this responsibility arise frequently, especially in select industries, and failure to comply can result in significant audit consequences.

Employers are ultimately accountable for any withholding tax liability as a result of failing to retain the appropriate withholding allowance certificates (or their electronic equivalents) and for failing to file copies of those wherein the employee requested more than 14 withholding allowances or where an employee claims exemption from withholding.

⁸ New York Tax Law §639(a).

⁹ 20 NYCRR §171.4.

Measuring income tax withholding audit risk

Audit reports allow the Department to complete a comprehensive field audit assessment. Any compliance gaps within an employer's withholding procedures can result in a significant assessment of tax, interest and penalties. Employers (specifically, responsible officers) remain financially responsible for all assessments, including underwithheld tax.

If the employer failed to withhold New York state (or local) income taxes, employees are technically obligated to pay these taxes when filing their New York individual income tax returns. Although the employees' payment of the tax relieves the employer from owing the underwithheld portion of the tax, the reality is that employees (in particular, New York nonresidents) are likely not to file a New York tax return or pay the tax owed. Consequently, employers may be saddled with the additional burden of paying the underwithheld tax, as well as the additional interest and penalties for failing to report and timely remit the tax to the Department.

Considering how often employers are held responsible for the underwithheld amount and the substantial financial consequence resulting from this failure, they should factor this underlying liability into their analysis and treat it as an essential part of the overall risk assessment.

It is incumbent on employers to review internal policies and procedures to assess whether reporting gaps could expose them to additional tax, interest and penalties during a New York income tax withholding audit. New York's income tax withholding audits are comprehensive and technology-assisted, and its examiners are trained to highlight and act on all explained anomalies. Employers should prepare accordingly and deploy proper internal governance to avoid preventable audit assessments.





New York's income tax withholding audits are comprehensive and technology-assisted, and its examiners are trained to highlight and act on all unexplained anomalies. Employers should prepare accordingly and deploy proper internal governance to avoid preventable audit assessments.

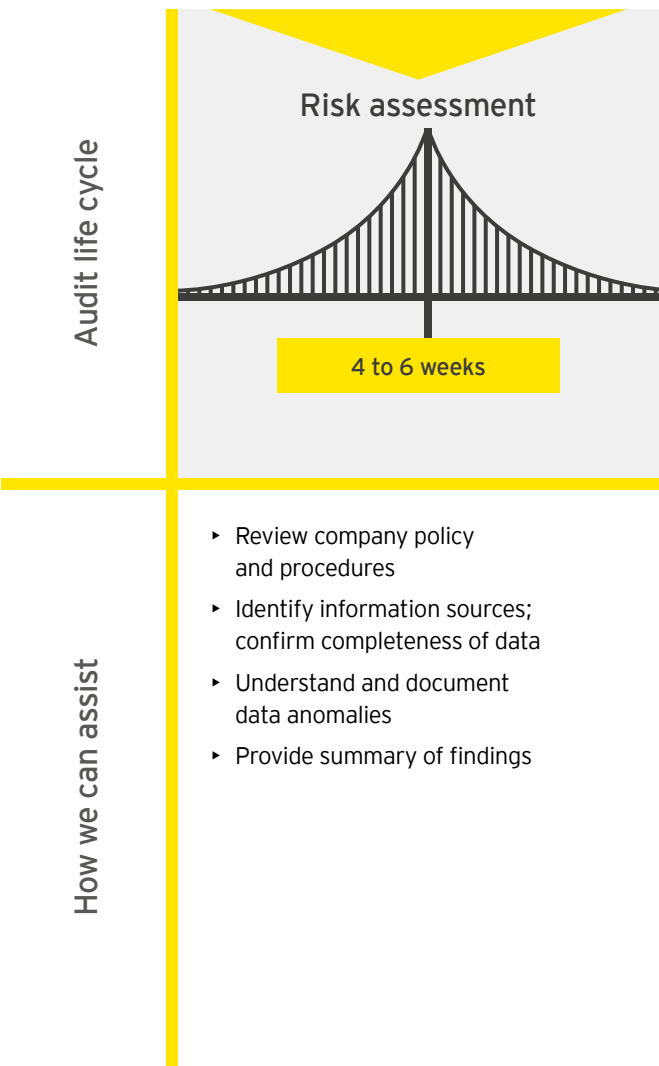
What can businesses do?

Employers have multiple remedies to self-correct gaps in their governance of employment tax withholding and reporting. For instance, some employers may believe that risk exists which may warrant proactively coming forward under New York's Voluntary Disclosure and Compliance Program to remediate historical errors. Under the program, the employer sets forth the facts and parameters of the disclosure to the Department with the ultimate goal of satisfying liabilities. If successful, the employer can limit its exposure, be relieved from penalties and maintain confidentiality.

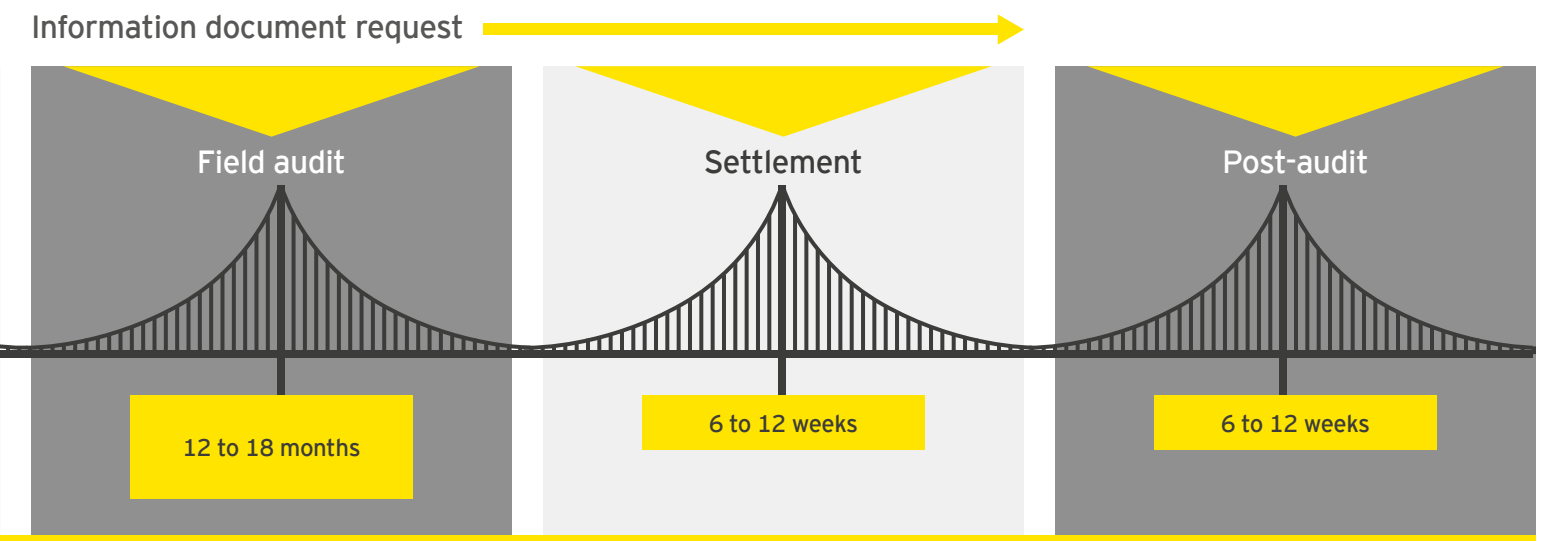
Employers might also consider undertaking the rigor of their own internal audit reviews, akin to the income tax withholding audit, to identify compliance gaps and risks. As part of this process, an employer can look at its current withholding policies and determine whether to refresh and update them or to implement a more comprehensive plan to strengthen overall compliance.

Regardless of what they choose and what challenges they face with compliance or an audit examination, employers should always be positive and take steps to evaluate current risks and potential future liability. A precise road map is fact-specific and employer-dependent, but, ultimately, pre-emptive action can prove invaluable.

New York income tax withholding audit examination timeline



Information document request



- Serve as liaison with the New York auditor
- Codevelop initial response to audit questionnaires and notices
- Prepare responsive materials to the [information document request \(IDR\)](#), including preparation of electronic data files; gap mitigation; footnote exceptions; and document assessments that should not apply
- Participate in agency conferences

- Seek executive waivers
- Review penalty assessment accuracy
- Facilitate agency discussion of audit terms
- Review and explain final audit assessment
- Coordinate audit closing steps, including preparation of amended employer returns
- Assist with employee communications and tax return preparation
- Develop steps for, and assist with, ongoing monitoring

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

Ernst & Young LLP

Employment Tax Advisory contacts

Anthony Arcidiacono
anthony.arcidiacono@ey.com
+1 732 516 4829

Peter Berard
peter.berard@ey.com
+1 212 773 4084

Gregory Carver
gregory.carver@ey.com
+1 214 969 8377

Bryan De la Bruyere
bryan.delabruyere@ey.com
+1 404 817 4384

Jennie DeVincenzo
jennie.devincenzo@ey.com
+1 732 516 4572

Richard Ferrari
richard.ferrari@ey.com
+1 212 773 5714

David Germain
david.germain@ey.com
+1 516 336 0123

Julie Gilroy
julie.gilroy@ey.com
+1 312 879 3413

Ken Hausser
kenneth.hausser@ey.com
+1 732 516 4558

Jessica Heroy
jessica.heroy@ey.com
+1 704 331 1869

Jimmy Kennedy
jimmy.kennedy@ey.com
+1 732 516 4170

Nicki King
nicki.king@ey.com
+1 214 756 1036

Kristie Lowery
kristie.lowery@ey.com
+1 704 331 1884

Candylin Mendoza
candylin.mendoza@ey.com
+1 212 773 3664

Chris Peters
christina.peters@ey.com
+1 614 232 7112

Matthew Ort
matthew.ort@ey.com
+1 214 969 8209

Gino Petrozzi
gino.petrozzi@ey.com
+1 615 252 2065

Debera Salam
debera.salam@ey.com
+1 713 750 1591

Debbie Spyker
deborah.spyker@ey.com
+1 720 931 4321

Mike S. Willett
mike.willett@ey.com
+1 404 817 4637





Get on board with mobile workforce income tax

ey.com/us/getonboard

#EYGetOnBoard

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

Ernst & Young LLP does not bear any responsibility whatsoever for the content, accuracy or security of any links (by way of hyperlink or otherwise) to external websites.

© 2016 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 00856-161US
CSG No. 1604-1924846 SW
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com

Connect with us



Follow us on Twitter



Join us on LinkedIn: *Payroll Perspectives from EY*