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COVID-19 Pandemic Is Creating Important Tax Implications for Those Working From Home

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BY MIKE KOSNITZKY

During the pandemic families have had to shelter in place and both parents and adult children have been forced to work from home. Given the lack of a vaccine, this trend may continue for quite some time. It is difficult to predict if these societal changes will have a long-term effect. For example, Facebook recently announced that it will begin allowing certain employees to permanently work remotely and, within a decade, Facebook expects that half of its employees will do so.

These changes may ultimately migrate into being the accepted business practice in other industries and professions. State boundaries may become far less significant and professional licensing rules may be forced to adjust to this changed workplace dynamic. There will also be important tax implications when people regularly work from home. The IRS and many state and local taxing authorities do not subscribe to the quaint notion of home being a place where one's heart is and it is important to note that states have their own rules governing the authority to tax that are limited only by Constitutional considerations. Some states, like New York, apply a dual test empowering the state to tax persons who either meet an annual statutory day's test or a domicile test. N.Y.S. Tax Law Section 605(b). To illustrate, a taxpayer who maintains a permanent place of abode becomes a statutory resident on his 184th day in New York. The taxpayer is then required to pay tax in New York on his worldwide income.

A taxpayer's domicile is the principal location to which he intends to return whenever

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absent. New York (and other states) consider the following factors in determining domicile: (i) the use and maintenance of the home in the state compared to another home outside of the state; (ii) patterns of business activities in the state; (iii) comparative time spent in the state; (iv) location of items with sentimental value; (v) family connections particularly the location of a taxpayer's spouse and children.

Complicating matters is that both Florida and Texas, states with no state individual income tax and therefore highly desirable locations for tax residency, have no general rules for establishing residency. To take advantage of Florida's favorable homestead property exemption rules (providing for a reduction in the property's taxable value by as much as $50,000 and an annual assessment cap) the taxpayer must prove residency through a facts and circumstance analysis which includes the following factors contained in Fla.Stat.Ann. § 196.015 (i) formal recorded declaration of domicile; (ii) evidence of where dependent children are registered for school; (iii) place of employment; (iv) previous permanent residency and date terminated; (v) voter registration with the address of the property's physical location; (vi) Florida driver's license or Florida identification card and evidence of relinquishment of driver's licenses from any other states; (vii) issuance of a Florida license tag; (viii) address as listed on filed federal income tax returns; (ix) location where the bank statements and checking accounts are registered; and (v) proof of payment for utilities.

Texas has a similar homestead exemption for school taxes if the home is the taxpayer's "principal residence." Tex. Tax Code § 11.13(b). To qualify, the home's owner must be an individual and use the home as his principal residence on January 1 of the tax year. Establishing a taxpayer's home as a homestead, eligible for the property tax exemption is important evidence when a taxpayer is attempting to demonstrate that he is not a domicile of another, presumably higher tax, jurisdiction. Applying for the homestead exemption evidences intent because it requires the taxpayer to establish that the home is his principal residence. But what happens when the presumptive Texas or Florida resident is forced to shelter in place in a higher tax state for a prolonged period? Second homeowners may then find themselves subject to state tax in another state because their domicile may have shifted.

Most states have not issued guidance on whether they will count the days in quarantine toward state residency tests. As a general rule, visitors to a state are generally allowed to stay there if they are ill and not be subjected to state taxation, but it is unclear how they will be treated if they are stuck in the state under a shelter-in-place order. The IRS has issued some guidance on this in an analogous situation involving nonresident aliens who are stuck in the United States during the pandemic.

Unless a tax treaty applies, an individual is treated as a U.S. tax resident during a taxable year and subject to U.S. federal income tax on worldwide income if such individual is physically present in the U.S. for 183 days or more or if his days in the U.S. equal 183 or greater using a three year weighted average formula. I.R.C. §7701(b)(3). However, under a medical exception, days are ignored if the nonresident "was unable to leave the United States because of a medical condition that arose while such individual was present in the United States." The Regulations require a nonresident to establish: (i) whether he would have remained in the U.S. anyway if the medical problem had not occurred; and (ii) whether the medical condition arose before he arrived in the U.S. I.R.C. §7701(b)(3)(D)(ii) and Treas. Reg. §301.7701(b)-3(c). If either of these conditions apply nonresidents who exceeded their days of presence in the U.S. would have been U.S. tax residents.

Rev. Proc. 2020-20 specifically provides limited relief for nonresidents who, but for travel disruptions caused by the pandemic, would not have been in the U.S. long enough to meet the days test. Under the revenue procedure, a nonresident can

exclude up to 60 consecutive days of U.S. presence that are presumed to arise from these travel disruptions. The travel restrictions will thus be considered a medical condition that prevented the nonresident from leaving the U.S. Furthermore, the guidance clarifies that there is a presumption that a person intended to leave the United States but was unable to do so.

Separate from the issue of physical presence is the issue of where services are performed, and which states gets to tax the income. Sourcing rules generally dictate that income is sourced based on where the service is performed. If a nonresident of New York regularly commutes from his home in New Jersey, for example, to a job in Manhattan, then New York State will subject the income earned in New York to taxation. The same rule applies if the taxpayer worked from home for his own convenience. But if the taxpayer is now working from home because of the pandemic then New York would presumably no longer have a claim on such income as the failure to commute was not for the convenience of the employee.

New Jersey in an FAQ stated that during the temporary period of the pandemic, wages will continue to be sourced as determined by the employer in accordance with the employer's jurisdiction and it will not impose a tax on the income of people who usually work in another state but are now working from home in New Jersey because of the pandemic. New York has not issued guidance on whether it will tax the income of taxpayers who are resident in another state and who regularly commute to New York but cannot do so because of the pandemic.

The pandemic may also have an impact for federal income tax purposes. The identification of a taxpayer's "tax home" is critical to the determination of whether travel expense deductions are allowed because deductions for traveling expenses are only permitted when "away from home." The IRS has long held the belief that a "tax home" is the place at which the taxpayer conducts his "trade or business" and not a personal residence.

IRS § 162(a)(2) provides a deduction for all ordinary and necessary expenses paid as "traveling expenses (including expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business…." Some guidance is provided in Treas. Reg. § 1.162-2 but the regulation does not address the definition of a "tax home." Rather, guidance is through case law and rulings. Authorities fall into two distinct camps: (i) those that find that a "tax home" is the location of the "principal place of business" and (ii) those that find that a "tax home" is the "permanent place of abode." In many cases, a taxpayer's "principal place of business" and "permanent place of abode" are one and the same. In those instances, the determination of "tax home" is uncomplicated; however, the determination of "tax home" becomes much more complex when taxpayers, courts and the IRS deal with divergent places of business and abode, multiple places of business, and multiple abodes.

The pandemic has only amplified these existing complexities. When taxpayers work from their primary residence or from a second residence because of a stay at home order or for their own welfare, do these homes become their new principal places of business? Have their homes become secondary business locations or temporary business locations? Under the IRS view, travel expenses paid with respect to a location that is the taxpayer's principal place of business are generally not deductible while travel expenses paid with respect to secondary and temporary (as opposed to an assignment of indefinite duration) business locations are deductible. See,

I.R.S. Topic No. 511 and I.R.S. Publication 463.

If a home has become the taxpayer's principal place of business, then he may deduct certain direct and prorated home office expenses subject to the strict requirements of I.R.C. §280A(c)(1). To be deductible, these home office expenses must be allocable to a portion of the home which is exclusively used on a regular basis as (i) the principal place of business for any business of the taxpayer; (ii) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his business; or (iii) in the case of a separate structure which is not attached to the home, in connection with the taxpayer's business. In the case of an employee, this favorable treatment will apply only if the exclusive use is for the convenience of the employer. In the context of the current pandemic and generally instituted employer requirement that employees must work from home, this IRS prerequisite should be satisfied. See, I.R.S. Publication 587.

Adding further complexity to these issues is the fact that several jurisdictions, including the Fifth Circuit, do not follow the IRS definition of tax home and the Supreme Court has never affirmed the IRS position of a tax home as being a taxpayer's principle place of business.

In *Commissioner v. Flowers*, 326 U.S. 465 (1946), rev'g 148 F,2d 163 (5th Cir. 1945), rev'g T.C. Memo 1944-263, the Court created a three-prong test to determine the deductibility of travel expenses. Under *Flowers*, the three factors to consider are that (1) the expense must be reasonable and necessary, (2) the expense must be incurred while away from home, and (3) the expense must be incurred in pursuit of business. The Court held that because the taxpayer's employer gained nothing from the taxpayer's decision to reside in a different city from his place of business, the expenses incurred were irrelevant to carrying on a trade or business and therefore the "pursuit of business" prong was lacking and the deductions denied.

Travel expenses incurred because of a taxpayer's personal choice of where to reside have been deemed nondeductible because they (1) are incurred while at or traveling to the taxpayer's principal business headquarters which is his tax home or (2) because there is no direct connection between the expenditure and the carrying on of the trade or business. Under a *Flowers* analysis, the fact that the taxpayer must work from home during the pandemic to benefit the employer as a matter of business exigency, would seem to satisfy the third prong of the test making these expenses deductible.

In sum, while in a colloquial sense a home may be where the heart is, for tax purposes the specific facts and technical rules must be studied and analyzed. The failure to do this may result in unintended adverse tax consequences or lost tax deductions.

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