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Accountants and Consultants

Subject:

New York State Issues Withholding Tax Field Audit Guidelines

State Tax Alert

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Date/Timing:

The New York State Department of Taxation (the Department) issued Withholding Tax Field Audit Guidelines on April 5, 2005 updating their previous guidelines issued on September 17, 2004.

Details:

On April 5, 2005, the Department released its auditors revised guidelines (New Guidelines) for auditing compliance with the requirement that corporations withhold New York State personal income tax on compensation paid to nonresident employees who work all or part of the time in New York. The New Guidelines make significant changes to the guidelines that were released in September, 2004 (Old Guidelines) and deal with numerous concerns that had been articulated by taxpayers. The New Guidelines do not replace existing law, regulations, form or publications but act merely as general guidance to the audit staff.

Generally, any employer that maintains an office or transacts business within New York State is required to withhold personal income tax on the compensation of any of its employees who work in the state. An "employer" is any person or organization qualifying as an employer on the basis of the instructions contained in Federal Circular E and maintaining an office or transacting business within New York State, whether or not a paying agency is maintained within the state. An entity's status as an employer is not tied to that entity's status as a taxpayer in New York State. For example, under federal Public Law 86-272, a foreign corporation is exempt from tax on or measured by income if its activities in a state are limited to the solicitation of orders by the corporation's employees, representatives or independent contractors for sales of personal property, which orders are sent outside or rejection, and which if approved, are filled by shipment or delivery from a point outside the state. However, this law does not relieve an employer, which is transacting business or is maintaining an office in New York State from

withholding taxes on employees of the corporation working in New York State. (N.Y. Reg. § 171.2).

“Wages” are defined as any form of compensation. In most instances, payments, which are considered wages for federal income tax withholding purposes, are also wages for purposes of withholding New York State personal income tax. In general terms, wages are any remuneration for services performed by an employee for his employer. (N.Y. Reg. § 171.3).

The Audit guidelines explain that the definition of “employees” depends on the business relationship that exists between the employer and the person performing the services. The person performing the services may be an independent contractor, a common-law employee, a statutory employee or a statutory non-employee.

If a New York State nonresident employee performs all of his or her services in New York State, personal income tax must be withheld from all wages paid to the employee in accordance with the employee’s withholding allowance certificate (federal Form W-4 or New York State Form IT-2104) unless any of the following apply:

1. The employee, either at the employer’s request or the employee’s, furnishes the employer with Form IT-2104.1. The IT-2104.1 must contain a certification that the employee is a nonresident and show the estimated percentage of services that will be performed in New York; or
2. The employer has adequate records to determine the proper amount of tax to be withheld from compensation for services performed in New York.

The employer may rely on a Form IT-2104.1 submitted by an employee as long as the employer does not have actual knowledge or reason to know that the Form IT-2104.1 is or has become incorrect or unreliable. If the employer has actual knowledge or reason to know that the IT-2104.1 is or has become incorrect or unreliable, it should determine the proper amount of withholding using the guidance above.

Employers should be aware that a nonresident employee whose primary work location is in New York is not allowed to consider a day worked outside of New York (for example, from home) for the convenience of the employee, as opposed to the necessity of the employer, as a day worked outside New York unless the employee does not enter New York during the tax year. An office in an employee's home is not considered to be a primary work location.

The audit division has adopted a new policy concerning the withholding requirements for employers who have nonresident employees that perform services both inside and outside New York State. The Tax Law requires that employers withhold on their employees, so far as practicable, an amount substantially equivalent to the tax reasonably esti-

mated to be due from the inclusion of the wages in the employees' New York adjusted gross income or New York source income (N.Y. Tax Law § 671(a)(1)). If a New York State nonresident employee performs services partly in the state, the employer is required to withhold 100 percent of the compensation unless any of the following apply:

1. The employee, either at the employer's request or the employee's, furnishes the employer with Form IT-2104.1. The IT-2104.1 must contain a certification that the employee is a nonresident and show the estimated percentage of services that will be performed in New York; or
2. The employer has adequate records to determine the proper amount of tax to be withheld from compensation for services performed in New York.

The employer is not required to withhold any New York tax if the employer reasonably expects the employee to perform services 14 or fewer days in New York for the tax year.

BDO Seidman recommends taxpayers to comply with the New Guidelines as soon as possible. The New Guidelines provide for a transitional period, giving taxpayers an opportunity to modify their payroll systems to comply with the new rules. The New Guidelines indicate that the transitional period will extend through the 2005 payroll cycle. In addition, taxpayers should be aware that audits of corporations relating to withholding issues could lead to audits of individual employees. In particular, corporate executives should be made aware that the Department may raise questions about their personal tax liability.

If these New Guidelines pertain to you or your employees, please contact BDO Seidman, LLP and we can review your current payroll systems and withholding mechanisms and determine if you are withholding properly for your nonresident employees. Although these guidelines are unique to New York State, many other states may soon follow their example, as nonresident withholding is required in most states; however, many states have not efficiently monitored and enforced the requirements and with State deficits climbing, it is an area that is sure to be audited.

**FOR MORE INFORMATION
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