I. INTRODUCTION

These guidelines have been established to ensure uniformity and consistency in examination of withholding tax records. The procedures and audit techniques apply to Article 22 of the New York State Tax Law.

Guidelines are issued to provide general guidance to audit staff. As with all guidelines, auditors must use discretion and common sense when applying these guidelines. These guidelines should be used to provide a general framework when conducting a withholding tax audit. An auditor must look at the specific facts and circumstances when conducting an audit and ensure that employers are in general compliance with the Tax Law and Regulations.

The guidelines do not replace existing law, regulations, forms or publications.

The withholding tax field audit program is designed to monitor compliance with the Tax Law and to safeguard the multi-billion dollar voluntary withholding tax base. It is not designed to place an undue burden on employers, nor to discourage employers from sending employees into New York State for business purposes.

This guideline attempts to address certain areas through examples, procedure statements, and common sense approaches. Audit staff should balance the audit process to ensure that New York State revenues are protected and, at the same time, economic activity in New York by non-resident employers and employees is encouraged, and that burdens placed on taxpayers are minimized.

Throughout the guideline, reference is made to withholding tax and/or New York State withholding tax. Where appropriate, this also includes withholding of New York City and city of Yonkers taxes.

The Tax Law and Regulations, court cases and Tribunal Decisions, along with Department policy materials, should be referred to when researching a particular issue. References to the Tax Law in these guidelines are meant to highlight general points of law and are not meant to be an authority on interpreting the Tax Law.

II. ***WITHHOLDING TAX LAW, REGULATIONS AND POLICIES***

New York State Tax Law provides for the withholding of New York State, New York City, and Yonkers personal income tax from wages of all resident employees for services performed either within or without of the taxing jurisdiction. The Tax Law also provides for income tax withholding from wages of nonresidents for services performed within New York State and Yonkers.

The responsibility of the employer to withhold personal income tax for New York State, New York City, and Yonkers is separate and distinct. Therefore, withholding a greater amount for one jurisdiction to cover a shortfall in another jurisdiction is inappropriate and is not permitted.

Regulation Section 171.1 states that every employer maintaining an office or transacting business within New York State must deduct and withhold from wages an amount of personal income tax that will result in withholding from the employee's wages an amount substantially equivalent to the New York State personal income tax reasonably estimated to be due as the result of the inclusion of the employee's wages received during the calendar year in the employee's New York adjusted gross income.

Regulation section 174.2 states: Every employer maintaining an office or transacting business within New York State and making payments of any wages taxable under Article 22 of the Tax Law to a resident or a nonresident individual whether or not such wages are sufficient to require the withholding of New York State personal income tax, and every employer required to file a wage reporting return pursuant to section 171-a of the Tax Law with respect to gross wages paid to at least one employee performing employment, whether or not such an employee is a resident of New York State for purposes of the Tax Law and whether or not such wages are subject to withholding of New York State personal income tax or payment of New York State personal income tax under article 22 of the Tax Law, must file quarterly combined withholding and wage reporting returns in accordance with the provisions of this section.

In general, the withholding provisions of the Tax Law parallel the federal Internal Revenue Code. The New York State Tax Law specifically adopts the federal terms such as "employer," "employee," "wages," "payroll period," and "withholding exemptions," except as otherwise specifically provided in Article 22 or where the federal rules and definitions are clearly inconsistent with and inapplicable to the provisions of Article 22 of the Tax Law.

A) EMPLOYERS

1) WHO ARE EMPLOYERS?

Section 171.2 of the Regulations state that 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 the State for approval 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. Public Law 86-272 prohibits an income tax where the only activity is the solicitation of orders. Withholding does not represent the imposition of an income tax on the employer. A foreign corporation which has employees that are performing services in New York State is transacting business and must withhold taxes from these employees, even though the corporation itself cannot be taxed.

Designation of third parties to perform acts required of employers - Regulation Section 177.1 states that the Tax Department may authorize a fiduciary, agent or other person to perform acts as required of employers. One example would be a Common Paymaster situation. All provisions of the Tax Law (including penalties) applicable to employers then become applicable to the third party. However, the employer also remains subject to all provisions of the Tax Law (including penalties).

Reporting or Service Agencies - Regulation Section 174.8 states that employers or groups of employers may utilize a reporting or service agency to file New York State employer's returns and remit payments of withheld taxes on their behalf. Examples of Reporting or Service Agencies would be payroll companies such as ADP, Paychex or Probusiness. The filing of New York State employer's returns and remittance of withheld taxes by a reporting or service agency on behalf of employers or groups of employers does not relieve each such employer from all provisions of law (including penalties) applicable in respect of employers.

2) WHAT ARE TAXABLE WAGES

Section 171.3 of the Regulations defines the term "wages" in general terms. 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. For additional information regarding the New York State withholding tax requirements for various types of income, please refer to the applicable chart in Publication NYS-50, *Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax.*

Income Tax Regulations Section 31.3401(a)-1 defines wages, in general, as all remuneration for services performed by an employee for his employer, and includes:

- Salaries, fees, bonuses, commission on sales or on insurance premiums, pensions, and retirement pay.

- Remuneration paid on the basis of piecework or a percentage of profits, and may be paid hourly, daily, weekly, monthly or annually.

- Remuneration paid in cash or something other than cash such as stocks, bonds, or other forms of property. If services are paid for in a medium other than cash, the fair market value of the thing taken in payment is the amount to be included as wages. If a corporation transfers to its employees its own stock as remuneration for services rendered by the employee, the amount of such remuneration is the fair market value of the stock at the time of the transfer.

- Remuneration for services even if at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them.

- Salary of an employee on vacation, paid notwithstanding his absence from work.

- Any payments made by an employer to an employee on account of dismissal, or involuntary separation from the service of the employer.

i) OTHER EXAMPLES OF WAGES SUBJECT TO WITHHOLDING TAX ARE:

Dividends vs. Compensation - Dividends of a corporation received by its shareholders instead of reasonable compensation in the same amounts for services performed are deemed to be wages for withholding tax purposes.

Employee tax paid by employer - If an employer pays any tax liability of the employee without making a deduction from his pay, the amount paid is wages.

ii) EXAMPLE OF WAGES NOT SUBJECT TO WITHHOLDING TAX:

Partner draws or salary - Bona fide partners are not employees of the partnership, and withholding tax does not apply to their partners' draws or salaries.

See Section 171.3 of the Regulations for other examples of where the term wages does not apply for the purposes of withholding New York State personal income tax.

3) REQUIREMENT OF EMPLOYERS TO WITHHOLD TAX

According to Section 671 of the New York State Tax Law, every employer maintaining an office or transacting business within New York State and making payments of any taxable wages to a resident or nonresident individual must deduct and withhold from such wages for each payroll period a tax computed in such a manner as to result, as far as practicable, in withholding from the employee's wages during each calendar year an amount substantially equivalent to the personal income tax reasonably estimated to be due resulting from the inclusion in the employee's adjusted gross income or New York source income of his wages received during each calendar year.

Limitation on assessment - Tax Law Section 683(b)(2) states that, if a return of withholding tax for any period ending with or within a calendar year is filed before April fifteenth of the succeeding calendar year, such return shall be deemed to be filed on April fifteenth of such succeeding calendar year.

4) EMPLOYER FILING AND PAYMENT REQUIREMENTS

Every employer required to deduct and withhold tax must file a withholding return and pay over the taxes so required to be deducted and withheld per the requirements set forth in Regulation Sections 174.1 and 174.2. These withholding tax filing rules and return requirements can also be found in the instructions for the withholding tax forms and in Publication NYS-50, *Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax.* Prior to 1999, these rules and requirements were located in Publication WT-100, *New York State Withholding Tax Guide*.

The withholding tax forms were revised for tax year 1999 and now differ from those utilized during tax years 1992 through 1998. A comparison summary between the old and new forms can be found in Appendix A of these guidelines.

Although the new forms beginning in 1999 include New York State Department of Labor Unemployment Insurance information, please note that the income tax auditor is not responsible for verification of Unemployment Insurance figures. If asked any questions, the auditor should refer the taxpayer to the phone numbers listed in Publication NYS-50 for the New York State Department of Labor.

FILING REQUIREMENTS:

1. Filers required to withhold less than $700 in a calendar quarter

   a) <u>Filing Rules</u>

Employers required to withhold less than $700 of state and local taxes in a calendar quarter shall remit their tax withheld with the quarterly combined return (Form NYS-45), whether or not they filed any Forms NYS-1 during the quarter. The quarterly combined withholding, wage reporting and unemployment insurance return (Form NYS-45) for the first three calendar quarters are due no later than the last day of the month following the end of the quarter. The fourth quarter return is due no later than February 28 of the succeeding year.

   b) <u>Return Requirements</u>

   i) **To report withholding and remit withholding tax**:

   Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return (Form NYS-45)

   ii) **To report quarterly employee gross wage information and to report annual wage and withholding information for each employee**:

   Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return (Form NYS-45), AND, IF MORE THAN FIVE EMPLOYEES, *Quarterly Combined Withholding and Wage Reporting Return Attachment (Form NYS-45-ATT)*

2. Filers required to withhold $700 or more in a calendar quarter

a) Filing Rules

An employer must file Form NYS-1 and remit the total tax withheld after each payroll that causes the total accumulated tax required to be withheld to equal or exceed $700. If the employer makes more than one payroll within a week (Sunday through Saturday), the employer is not required to file until after the last payroll in the week. However, when a calendar quarter ends between payrolls paid within a week, any accumulated tax required to be withheld of at least $700 must be remitted with Form NYS-1 after the last payroll in the quarter.

If an employer filed at least once during the calendar quarter, and has an unremitted balance of tax withheld that is less than $700 after the last payroll of the quarter, the employer may remit this amount with their quarterly return Form NYS-45 instead of with a Form NYS-1.

Every employer required to withhold taxes from wages or other payment (e.g., pensions) must file Form NYS-45, *Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return*, and detail the quarter's withholding tax transactions and wage reporting information. The employer must file a Form NYS-45 each quarter regardless of whether they were required to withhold tax for the quarter (unless they qualify as a seasonal employer).

Every employer must complete and file Form NYS-45 (or NYS-45-ATT if more than five employees) showing each employee who resides or is employed in New York State, whether or not the wages of such employee are subject to withholding of tax or payments of tax under Article 22 of the Tax Law. In addition, employers who were required to report 250 or more employee/payee records in the previous four consecutive quarters are required to file Forms NYS-45-ATT on magnetic media.

b) When Returns Are Due

If an employer was required to withhold less than $15,000 for the calendar year that precedes the previous calendar year, the employer's NYS-1 return and payment are due on or before the fifth business day following the payroll in which their tax withheld equaled or exceeded $700.

If an employer was required to withhold $15,000 or more for the calendar year that precedes the previous calendar year, their return and payment are due on or before the third business day following the payroll in which their tax withheld equaled or exceeded $700 (the tax department will notify the employer of their filing due date based on our record of their total tax due). New businesses have five business days to remit until they are notified by the Department to file within three business days.

As with employers with less than $700 in withholdings, the NYS-45 returns for the first three calendar quarters are due no later than the last day of the month following the end of the quarter. The fourth quarter return is due no later than February 28 of the succeeding year.

c) Return Requirements - Employers must file the following documents:

i) **To file and remit withholding tax**:

Return of Tax Withheld (Form NYS-1)

ii) **To report quarterly withholding tax reconciliation information**:

Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return (Form NYS-45)

iii) **To report quarterly employee gross wage information and to report annual wage and withholding information for each employee**:

Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return (Form NYS-45) AND, IF MORE THAN FIVE EMPLOYEES, *Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return Attachment (Form NYS-45-ATT)*

iv) **To amend quarterly withholding tax reconciliation information**:

Amended Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return. (Form NYS-45-X)

5) INFORMATION STATEMENT FOR EMPLOYEE

Regulation Section 172.1 states that every employer required to deduct and withhold tax from the wages of an employee, or who would have been required to deduct and withhold tax if the employee had claimed no more than one withholding exemption, shall furnish to each such employee on or before February fifteenth of the succeeding year, or, if his employment is terminated before the close of such calendar year, within thirty days from the date on which the last payment of the wages is made, a statement, in duplicate, on federal form W-2 *Wage and Tax Statement*, showing the amount of wages, tips and other compensation paid by the employer to the employee during the calendar year, the amount deducted and withheld as New York State personal income tax, and all of the other information required to be shown on such form.

Where federal form W-2 is required to be furnished to an employee, whether the employee is a resident or a nonresident, the total of such employee's wages, tips and other compensation with respect to services performed both within and without New York State must be reported in the *State Wages, Tips, etc.* box on such federal form W-2. For more information on this subject see TSBM-02(3)I, Employer Requirements Concerning the Reporting of New York State, City of New York, and City of Yonkers Wages Beginning with tax year 2003.

Employers need not file a copy of Form W-2 with New York State. Instead, employers must report annual wage and withholding information on the fourth quarter Form NYS-45 (or NYS-45-ATT, if applicable).

6) RETENTION OF RECORDS

Section 158.4(a) of the Regulations states that every employer or withholding agent required to deduct and withhold New York State personal income tax upon the wages of employees, and every person required to file New York State information returns must keep all records pertinent to withholding of New York State personal income tax and New York Sate information returns available for examination and inspection by the Tax Commission, or its authorized representatives.

Records with respect to New York State personal income tax withheld must be retained for a period of four years after the due date of the New York State personal income tax withheld for the return period to which the records relate, or the date the New York State personal income tax withheld was paid, whichever is later. Records with respect to New York State information returns must be retained for a period of four years after the due date of the New York State information return.

Regulation 158.4(b) describes the types of records that should be maintained by employers.

Regulation Section 158.4(c) states that, for nonresident employees performing services partly within and partly without New York State, a record of the allocation used for withholding purposes must be kept.

Regulation Section 2402.1 and Section 2402.2 contain a discussion of electronic record keeping and retention.

Regulation Section 171.6(b)(5) states that form IT-2104.1 must be retained by the employer and must be available for inspection.

EMPLOYEES

1) WHO ARE EMPLOYEES?

As explained in IRS Publication 15-A, *Employer's Supplemental Tax Guide*, the manner in which payments for services are treated depends upon 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 nonemployee.

Independent Contractors

People such as lawyers, contractors, subcontractors, public stenographers, and auctioneers who follow an independent trade, business, or profession in which they offer their services to the public, are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result.

Common-Law Employees

Under common-law rules, anyone who performs services is an employee if the employer can control what will be done and how it will be done. This is so even when the employer gives the employee freedom of action. What matters is that the employer has the right to control the details of how the services are performed.

If an employer-employee relationship exists, it makes no difference how it is labeled. The **substance** of the relationship, **not the label** governs the worker's status. Nor does it matter whether the individual is employed full time or part time.

For employment tax purposes, no distinction is made between classes of employees. Superintendents, managers and other supervisory personnel are all employees.

Corporate Officers

According to Section 3121(d)(1) of the Internal Revenue Code, the term employee also means any officer of a corporation. An officer of a corporation is generally an employee; however, an individual that sits on the board of directors is not. An officer who performs no services or only minor services, and neither receives nor is entitled to receive any pay, is not considered an employee.

Leased employees

Under certain circumstances, a corporation furnishing workers to various professional people and firms is the employer of those workers for employment tax purposes. For example, a professional service corporation may provide the services of secretaries, nurses and other similarly trained workers to its subscribers.

The service corporation enters into contracts with the subscribers under which the subscribers specify the services to be provided and the fee to be paid to the service corporation for each individual furnished. The service corporation has the right to control and direct the worker's services for the subscriber, including the right to discharge or reassign the worker. The service corporation hires the workers, controls the payment of their wages, provides them with unemployment insurance and other benefits and is the employer for employment tax purposes.

Statutory Employees

Four categories of workers who are independent contractors under the common law are treated by statute as employees. They are called statutory employees. **Income taxes are NOT required to be withheld from the wages of statutory employees.** Only social security, Medicare and FUTA (Federal Unemployment Tax) taxes are required to be withheld from wages paid to certain statutory employees.

1. A driver who distributes beverages (other than milk), meat, vegetable, fruit or bakery products, or who picks up and delivers laundry or dry cleaning, if the driver is your agent or is paid on commission.

2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.

3. An individual who works at home on materials or goods that the employer supplies and that must be returned to the employer or to a person the employer names, if the employer also furnishes specifications for the work to be done.

4. A full-time traveling or city salesperson who works on the employer's behalf and turns in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

Statutory Nonemployees

There are two categories of statutory nonemployees: **direct sellers and licensed real estate agents**. They are treated as self-employed for all federal tax purposes, including income and employment taxes, if:

1. Substantially all payments for their services as direct sellers or real estate agents are directly related to sales or other output, rather than to the number of hours worked, and

2. Their services are performed under a written contract providing that they will not be treated as employees for federal tax purposes.

Direct sellers - Direct sellers include persons falling within any of the following three groups:

1. Persons engaged in selling (or soliciting the sale of) consumer products in the home or place of business other than in a permanent retail establishment.

2. Persons engaged in selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale in the home or at a place of business other than in a permanent retail establishment.

3. Persons engaged in the trade or business of the delivery or distribution of newspapers or shopping news (including any services directly related to such delivery or distribution).

Direct selling includes activities of individuals who attempt to increase direct sales activities of their direct sellers and who earn income based on the productivity of their direct sellers. Such activities include providing motivation and encouragement; imparting skills, knowledge, or experience; and recruiting.

Licensed real estate agents - This category includes individuals engaged in appraisal activities for real estate sales if they earn income based on sales or other output.

Salespersons

To determine whether salespersons are employees under the common-law rules (as discussed in Section III, Part 6 of these guidelines), the auditor must evaluate each individual case. If a salesperson does not meet the tests for a common-law employee, the employer does not have to withhold income tax from his or her pay (see **Statutory Employees** earlier). However, even if a salesperson is not an employee under the usual common-law rules, his or her pay may still be subject to social security and Medicare taxes and FUTA taxes. To determine whether a salesperson is an employee for social security, Medicare, and FUTA tax purposes, the salesperson must meet **all** eight elements of the statutory employee test. A salesperson is an employee for social security, Medicare and FUTA tax purposes if he or she:

1) Works full-time for one person or company except, possibly, for sideline sales activities on behalf of some other person,

2) Sells on behalf of, and turns his or her orders over to, the person or company for which he or she works,

3) Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments,

4) Sells merchandise for resale, or supplies for use in the customer's business,

5) Agrees to do substantially all of this work personally,

6) Has no substantial investment in the facilities used to do the work, other than in facilities for transportation,

7) Maintains a continuing relationship with the person or company for which he or she works, and

8) Is not an employee under common-law rules.

2) DETERMINING TAX TO BE WITHHELD

Regulation Section 171.4 indicates that the amount of New York State personal income tax to be deducted and withheld by an employer must be determined in accordance with one of the following methods:

METHOD I - Wage Bracket Table Method
METHOD II - Exact Calculation Method

The wage bracket table method and the exact calculation method can be found in Publication NYS-50-T, *New York State, City of New York, and City of Yonkers Withholding Tax Tables and Methods.*

Supplemental Wages - If an employer pays supplemental wages (bonuses, commissions, overtime pay, sales awards, etc.) with regular wages but does not specify the amount of each, the employer should withhold income tax as if the total were a single payment for a regular payroll period.

If an employer pays supplemental wages separately (or combines them in a single payment and specifies the amount of each) the income tax withholding method depends partly on whether or not the employer withholds income tax from an employee’s regular wages:
If the employer withholds income tax from an employee’s regular wages, the employer can use one of the following methods for the supplemental wages.

A. Withhold at the supplemental rates; see Publication NYS–50-T for withholding tables.
B. Add the supplemental and regular wages for the most recent payroll period this year. Then figure the income tax withholding if the total were a single payment. Subtract the tax already withheld from the regular wages. Withhold the remaining tax from the supplemental wages.

If an employer does not withhold income tax from the employee’s regular wages, use method b. (this would occur, for example, when the value of the employee’s withholding allowances claimed on Form W-4 is more than the wages.

Vacation Allowances - Amounts of vacation allowances are subject to withholding as though they were regular wage payments made for the period covered by the vacation.

Payroll Periods - The New York State personal income tax is to be withheld on the basis of the same payroll period which is required to be used by the employer for federal income tax purposes.

Withholding Exemptions - In determining the proper New York State personal income tax to be deducted and withheld from an employee's wages, an employee is entitled to the same number of withholding exemptions as the number of New York exemptions such employee is allowed pursuant to section 616 of the Tax Law plus such additional New York State withholding allowances in accordance with forms and instructions of the Department of Taxation and Finance (see Form IT-2104, *Employee's Withholding Allowance Certificate and Instructions*). In lieu of New York State Form IT-2104, an employer may accept a properly completed federal Form W-4 from an employee, unless the employee has claimed “exempt” on Form W-4.

3) EMPLOYEES WITHHOLDING ALLOWANCE CERTIFICATE (IT-2104)

Regulation Section 171.4 states that in lieu of New York State form IT-2104, an employer may accept a properly completed federal Form W-4 from an employee. Regulation Section 171.4 also permits for situations where the employer must obtain a completed Employee's Withholding Allowance Certificate (Form IT-2104) from the employee. Additional information regarding the filing of Form IT-2104 is noted below.

a) If an employee has not filed a federal Form W-4, or if an employee wishes to claim withholding exemptions other than those claimed for federal income tax withholding purposes, the employer must obtain a completed Form IT-2104, Employees Withholding Allowance Certificate, from the employee. The employee shall be entitled to claim only those withholding exemptions allowable on a properly completed Form IT-2104.

b) If an employer is notified by the Internal Revenue Service that a federal Form W-4 for an employee is defective, then the number of exemptions allowable for New York State personal income tax withholding purposes for that employee is limited to the maximum number of withholding exemptions specified by the Internal Revenue Service, less the withholding exemptions allowed for federal credits, plus the number of additional New York State withholding allowances claimed on a properly completed Form IT-2104.

c) An employer must submit a copy of any Form IT-2104, together with a copy of any written statement received from the employee in support of the claims made on the certificate, if the employee is employed by that employer on the last day of the reporting period and if the total number of withholding exemptions and allowances claimed on the Form IT-2104 exceeds 14.

d) Employers are required to submit a copy of an IT-2104, or make the original available for inspection, upon written request of the Tax Department.

The auditor may request verification of the submission of an IT-2104 to New York State. All requests should be made through Field Audit Management, and require the tax year Form IT-2104 was sent to New York State, the tax years under examination, employer name, employer identification number, employee name and employee social security number.

4) DETERMINING TAX TO BE WITHHELD ON WAGES PAID TO NEW YORK STATE RESIDENTS

Regulation Section 171.5 states that all wages paid to a resident of New York State are subject to withholding of New York State personal income tax, even though some or all of the services for which the wages are paid were performed outside New York State.

In addition, an employer required to deduct and withhold income taxes of other states, political subdivisions of other states, or the District of Columbia, from wages paid to a resident of New York State, must also deduct and withhold New York State personal income tax from those wages. The amount of New York State personal income tax to be deducted should be determined under the applicable wage bracket withholding table or other method provided for in Section 171.4 of the Regulations, less the amount required to be deducted and withheld from those wages under the laws, rules and regulations of such other states, political subdivisions, or the District of Columbia.

Example 1: An employer transacting business in New York State has a New York State resident employee working in both New York and neighboring State A. The amount of wages earned in State A is $70 per week and in New York is $30 per week. If one exemption is claimed by the employee, the employer is required by State A law to deduct State A tax of $1.53. The amount of New York State tax to be withheld on $100 is $2.60; however, according to Section 171.4 of the Regulations, the amount of New York State personal income tax required to be withheld is reduced by the State A tax withheld. Thus, this employer is required to withhold and submit $1.07 ($2.60 less $1.53) to New York State for this employee.

Example 2: An employer transacting business in New York State has a New York State resident employee working in both New York and neighboring State B. The wages earned in State B are $100. If one exemption is claimed by the employee, the employer is required to deduct $3.34 for State B tax. The amount of New York State tax to be withheld on $100 is $2.60. Since the State B amount is above the $2.60 New York State tax required to be withheld, under Section 171.4 of the Regulations, no New York State tax would be withheld.

Determining residence status of employees - Employers may rely on information provided by employees regarding residence, provided the information is accepted by the employer in good faith, and the employer did not have any actual knowledge or reason to know the statement is incorrect or unreliable. Forms W-4, IT-2104, IT-2104-E, IT-2104.1, etc., represent examples of acceptable methods of employee address notification.

For example, an employee working in New York provides a New Jersey address as his or her primary residence. The employee's actual home address and domicile is in New York City. The employer has no record or knowledge of the employees' actual address. In this situation, the employer may withhold based on the New Jersey principal address and may treat the employee as a nonresident of New York State and New York City. The employee is then responsible for filing correct tax returns and paying applicable New York State and New York City resident taxes. However, if the same employee maintains control of all financial transactions of the business, the employer is then deemed to have had actual knowledge and should have withheld the appropriate New York State and New York City taxes.

Statutory resident - There is no burden on an employer to determine if a nonresident employee may be held taxable as a New York resident based on the 183 day rule, provided the employer is not aware of a New York address.

For example, an employee working in a New York office provides a New Jersey address as his or her primary residence. The employee is also a statutory resident of New York State and New York City but never communicates that fact in accordance with the employer's procedures. In this situation, the employer may withhold based on the New Jersey principal address and may treat the employee as a nonresident of New York State and New York City. The employee is then responsible for filing correct tax returns and paying applicable New York State and New York City resident taxes.

5) DETERMINING TAX TO BE WITHHELD ON WAGES PAID TO NEW YORK STATE NONRESIDENTS

Nonresident employees who perform all services in New York State

- 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) and the applicable withholding methods as shown in Publication NYS-50-T, *New York State, City of New York, and City of Yonkers Withholding Tax Tables and Methods*. An employer may not accept Form IT-2104.1 estimating the percentage of wages attributable to services performed in New York State from such employee.

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.

Example 1: Employee A is a New York State nonresident employee who is assigned to work in the employer's New York office. Employee A has no work assignments that require him to perform any services outside of the New York office. Employee A submits a Form IT-2104.1 to his employer estimating the percentage of wages attributable to services performed in New York State as 90%. The employer may not accept the form since the employer has actual knowledge that employee A performs 100% of his services in New York State. The employer must withhold New York State personal income tax on **all** wages paid to employee A. If the employer did accept the form and only withholds on 90% of employee A's wages, the employer would be liable for any additional tax, penalty, and interest on employee A's under withholding.

Example 2: Employee B is a New York State nonresident employee assigned to the employer's New York office. The employer has a telecommuting program which allows employees to work from their homes. Employee B participates in this program and works two days per week in the New York office and three days per week at home. The work employee B performs at home is the same work employee B performs in the New York office. Employee B submits a Form IT-2104.1 to the employer estimating the percentage of wages attributable to services performed in New York as 40%. The employer may not accept the form since the employer has actual knowledge that it is not correct. (Days worked at home for the convenience of the employee, as opposed to necessity of the employer, are considered days worked in New York.) The employer must withhold New York State personal income tax on **all** wages paid to employee B. If the employer did accept the form and only withholds on 40% of employee B's wages, the employer would be liable for any additional tax, penalty, and interest on employee B's under withholding.

Nonresident employees who perform services both in and out of New York State

- If a New York State nonresident employee performs services partly in the state, only the wages for services performed inside the state are subject to withholding of New York State personal income tax.

- 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 estimated to be due from the inclusion of the wages in the employees' New York adjusted gross income or New York source income (Tax Law section 671(a)(1). The new policy addresses what factors and statements an employer should consider in determining what the reasonable estimate of tax due should be. The policy allows employers to rely on the guidelines set forth below with respect to the requirements of Tax Law section 671(a)(1).

  Also, as part of the new policy the audit division recognizes that withholding will not be required on wages paid to certain employees who are assigned to a primary work location **outside** of New York State who perform services in the state for 14 or fewer days during the calendar year. (Please refer to 14 day guidance below).

- This new policy is effective as of the date of issuance of these guidelines, and should be incorporated into all open audits.

Transitional period - The auditor should take a transitional period into consideration when deciding whether to impose or not impose penalties on nonresident withholding issues. For example, if a company is making reasonable efforts to comply with nonresident withholding requirements, including but not limited to implementing and perfecting new systems for nonresident withholding, the auditor may decide not to impose penalties on nonresident issues if there are no other facts present which would warrant imposition of penalties.
The transitional period will extend through the 2005 payroll cycle.

- **Nonresident employees assigned to a primary work location within New York State who perform services both in and out of New York State**

In determining the proper amount of wages subject to New York State withholding, an employer may rely on the guidance below.

- If a nonresident employee’s primary work location is located in New York State, then the employer will be required to withhold on 100% 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 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 redetermine the proper amount of withholding using the guidance above.

An employer is considered to have reason to know that Form IT-2104.1 is incorrect if its knowledge of relevant facts or of statements contained in the form is such that a reasonably prudent person in the position of the employer would question the claims made.

An employer is considered to have actual knowledge or reason to know that Form IT-2104.1 has become incorrect or unreliable if a reasonably prudent person in the position of the employer would question the accuracy of the Form IT-2104.1 which is on file.

An employer is deemed to have actual knowledge or reason to know that Form IT-2104.1 has become incorrect if there has been a significant change in the employee’s work assignment or the employee gives the employer information which indicates the employee has become a New York State resident. Significant changes in work assignment include, but are not limited to: promotions, change of primary work location (either permanent or for a significant temporary period) and a change in duties.

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.

Employers may not accept or rely on a Form IT-2104.1 that shows a percentage of less than 100% if the employee's primary work location is New York and the employer reasonably expects the employee to have no duties assigned outside New York.

Employees who expect to perform no services in New York may submit, but are not required to submit, an IT-2104.1 to their employer estimating a percentage of services performed in New York of 0%. The employer may rely on the IT-2104.1 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.

What follows are examples of how this guidance will work.

Employee M and Employee N are system analysts assigned to Corporation R's New York office. Employee M and Employee N are both nonresidents of New York. Both employees have historically performed services in New Jersey on an as needed basis which is determined based on the particular project that they are assigned to. On January 2, 2001, both employees submit an IT-2104.1 to their employer estimating the percentage of services performed in New York as 65%. The supervisor of the two employees reviews the IT-2104.1 forms submitted and, based on past experience and a reasonable estimate of work in the foreseeable future, approves the IT-2104.1 forms and submits the forms to the payroll department. The employer therefore accepts the two IT-2104.1 forms and has no actual knowledge or reason to know that they are incorrect. During calendar year 2001, both employees continue to perform services which are typical of past years and could reasonably be expected to yield a work percentage of 65%. On March 15, 2002 Employee M is assigned a project which will require Employee M to work in New York for 85% of his time for the next two years. In this instance, the employer could no longer rely on the IT-2104.1 submitted by Employee M on January 2, 2001, since the employer has reason to know or actual knowledge that the IT-2104.1 has become incorrect or unreliable. The employer knows this since there has been a significant change in Employee M's work assignment. If the employer were to continue to rely on the IT-2104.1 submitted by Employee M after March 15, 2002, the employer would be liable for any additional tax, penalty and interest on Employee M's underwithholding. Since there has been no significant change to Employee N's assignment the employer could continue to rely on the IT-2104.1 submitted by Employee N. On June 2, 2002 Employee P is hired by the corporation. Employee P is a nonresident of New York and is a system analyst assigned to the same project as Employee M. On June 2, 2002, Employee P submits an IT-2104.1 to his employer estimating the percentage of services performed in New York as 65%. The employer can not accept or rely on this IT-2104.1 since the employer has actual knowledge that system analysts working on this particular project are expected to perform 85% of their services in New York. If the employer were to accept and the IT-2104.1 submitted by Employee P and withhold on only 65% of Employee P's wages, the employer would be liable for any additional tax, penalty and interest on employees P's underwithholding.

Employee E is an executive and officer of Corporation C and is assigned to the Corporation C's New York office. Employee E is a nonresident of New York State. Corporation C has 5 employees and Employee E maintains control of all financial transactions of the business. On January 2, 2003 Employee E submits an IT-2104.1 to his employer estimating the percentage of services performed in New York as 50%. Employee E has always performed between 90% to 95% of his services in New York and is expected to continue to perform between 90% to 95% of his services in New York in the future. The employer may not accept the IT-2104.1 since Corporation C has actual knowledge it is not correct. If the employer were to accept the IT-2104.1 and withhold on only 50% of Employee E's wages, the employer would be liable for any additional tax, penalty and interest on Employee E's underwithholding.

Employee F is a customer service representative assigned to Corporation D's New York office. Corporation D has forty thousand employees and fifteen thousand of these employees work in New York. Employee F is a New York nonresident. Employees in employee F's department and in employees F's job title perform 98%-100% of their services in New York. Employee F performs services which are typical for employees in Employee F's department and job title On January 2, 2003 Employee F submits an IT-2104.1 to his employer estimating the percentage of services performed in New York as 10%. The employer may not accept the IT-2104.1 since the employer has actual knowledge it is not correct. The employer has actual knowledge because employees in F's job title and department do not perform 10% of their services in New York. If Corporation D were to accept the IT-2104.1 and withhold on only 10% of employee F's wages, Corporation D would be liable for any additional tax, penalty and interest on Employee F's underwithholding.

- Nonresident employees assigned to a primary work location outside New York State who perform services both in and out of New York State

In determining the proper amount of wages subject to New York State withholding, an employer may rely on the guidance below.

- If a nonresident employee's primary work location is located outside of New York State and the employee performs services in New York State, then the employer will be required to withhold on 100% 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.

  3. 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[1]. For more information on the 14 day guidance see the section entitled "Wages paid to nonresident employees who work in New York for 14 or fewer days".

[1]Although withholding is not required under this new guidance, employers may withhold if they elect to do so.

Note: Option 3 does not apply to payments of wages to nonresident athletes and entertainers or to payments of deferred compensation or nonstatutory stock options. (Further information regarding the 14 day guidance, deferred compensation and nonstatutory stock options are contained in this section of the guidelines pages 25-26)

The employer may rely on a Form IT-2104.1 submitted by an employee as long as it does not have actual knowledge or reason to know that the form is incorrect or unreliable.

What follows are examples of how this guidance will work.

Employee D is an executive of Corporation B and is assigned to the Corporation Headquarters located outside of New York. Corporation B has 15,000 employees. Employee D is a nonresident of New York State. Employee D occasionally travels to New York to perform services. On January 2, 2003 Employee D submits an IT-2104.1 to his employer estimating the percentage of services performed in New York as 10%. . Corporation B accepts the IT-2104.1 and has no actual knowledge or reason to know it is incorrect and withholds on 10% of the employee's wages. The actual percentage of services performed in New York for calendar year 2003 was 20%. The amount of tax underwithheld is not the responsibility of the employer. If the employer is audited, no adjustment for tax, penalty or interest for the under withholding on Employee D will be assessed. The auditor should advise the employer that in the past the IT-2104.1 submitted by Employee D was not accurate and the employer should ask Employee D for a new IT-2104.1 if it is appropriate.

Employee G is a nonresident employee assigned to Corporations E's New Jersey office. On January 2, 2003 Employee G submits an IT-2104.1 to her employer estimating the percentage of services performed in New York as 25%. On June 1, 2003 Employee G changed her work location to New York and changed her job title. Employees in her new job title and new job location typically perform 95% of their services in New York. Employee G does not submit a new IT-2104.1 to her employer. The change in work location and job title are recorded in Corporation E's records. The employer must adjust Employee G's withholding, since Corporation E has actual knowledge the IT-2104.1 on file is not correct. If the employer has adequate records to determine the proper amount of tax to be withheld, the withholding on Employee G may be adjusted to this amount; in the absence of adequate records, withholding must be adjusted to 100%. If Corporation E continues to rely on and withhold based on the IT-2104.1 on file, Corporation E would be liable for any additional tax, penalty or interest on Employee G's underwithholding.

Individual employees are responsible to properly compute their respective New York source income on their New York State IT-203 personal income tax returns. In situations where the employer has withheld pursuant to an IT-2104.1 and did not have actual knowledge or reason to know it is incorrect, and the auditor knows or suspects the percentage is not correct, the auditor should view the New York State wage allocation on the employee's personal income tax return. If the auditor feels the individual is not properly allocating the wages to New York, an individual audit case should be created.

The IT-2104.1 and the Audit Process - it has been our experience on audit that most employers do not make extensive use of Form IT-2104.1 and in general will withhold based on the employee's work location. The review of Form IT-2104.1 and its significance in the audit process has been minimal to date. Under the new policy the auditor may begin to encounter employers who have on file large numbers of Form IT-2104.1. If this is the case, the auditor will have to include the review of Form IT-2104.1 in the audit plan.

The employer should be asked how the IT-2104.1 process works. If the employer states that employees are sent a yearly reminder to file an IT-2104.1, these forms are then sent directly to payroll where a clerk enters them into the payroll system, and the payroll clerks enter all IT-2104.1's into the system without any checks or edits, this would be an example of a system where the employer has little or no control over the IT-2104.1 process. The auditor would then have to carefully review the IT-2104.1's to verify that they are accurate and that the employer did not rely on IT-2104.1 forms which the employer had actual knowledge or reason to know were not correct.

The auditor should ask the employer to provide a listing of all employees with IT-2104.1's on file and a listing of each employee's job title and work location. If an EDP audit is being conducted, this information can be obtained in electronic format. The auditor will then be provided a report showing all employees that completed an IT-2104.1, as well as each employee's work location and job title. These reports, in conjunction with other information obtained from the employer, will allow the auditor to verify whether the employer relied on IT-2104.1's which they had actual knowledge or reason to know were incorrect. An employer cannot claim it does not have actual knowledge or reason to know if the business does not have a system in place to verify that the IT-2104.1's received from employees are accurate.

If the auditor determines certain IT-2104.1 forms were accepted, and the employer had actual knowledge or reason to know they were not correct, the auditor should assess any additional tax, penalty and interest against the employer.

If an employer documents to the auditor it has in place a system where it takes certain steps to verify the accuracy of completed IT-2104.1 forms, and the auditor determines this system is functioning properly, the amount of time spent auditing this issue can be reduced. For example, the employer has a system in place where, after an IT-2104.1 is submitted, the employee's supervisor is notified, is given a brief description of the significance of the form, how the form should be used, and the supervisor is asked to verify and approve the IT-2104.1. The employer also has in place a system where, whenever an employee changes work location or job title or any other significant change in the employees work assignment, they are required to fill out a new IT-2104.1. Further, the employer also has in place a system where, when an employee notifies the employer of a new address and the new address indicates a change of residence from nonresident to resident status, withholding is adjusted to reflect the change in residence status. The more systems and checks the employer has in place to make sure the IT-2104.1 process is working properly, and the greater the application of the employers actual knowledge about employee working percentages in New York to the IT-2104.1 process, the less time the auditor will have to spend examining this issue.

The actual knowledge or reason to know tests should be administered in a reasonable manner, taking into account the facts and circumstances of each employer. In some instances, it would not be reasonable for an employer's payroll department to have knowledge of all the facts and circumstances that are possessed by the company as a whole as it relates to the work location of an individual nonresident employee.

As previously noted, in situations where the employer has accepted an IT-2104.1 and had no actual knowledge or reason to know it was or became incorrect, and the auditor knows or suspects the percentage is not correct, the auditor should review the employee's personal income tax return. If the auditor feels the individual is not properly allocating wages, an individual audit case should be created.

The actual knowledge or reason to know standard will also apply to separate IT-2104.1's submitted for withholding on stock options and deferred compensation amounts.

An auditor may find that an employer under audit has implemented a time and attendance system and does not make use of Form IT-2104.1 for all or some of its nonresident employees who perform services both within and without New York. A time and attendance system requires employees to specify where they are performing services on a daily basis. This information becomes part of the payroll system and allows the employer to do extremely accurate withholding on nonresident employees who perform services both within and without New York. This type of system can be very useful when employers have employees whose work schedule is highly variable, such as a consultant who works in multiple states on an as needed basis. If an employer utilized an IT-2104.1 for such an employee in lieu of a time and attendance system, the employer would be put into the position where it has to continually get a new IT-2104.1 for every significant change in work assignment. If an auditor encounters a time and attendance system on audit and the auditor has determined the system is well designed and is functioning properly the auditor can reduce the amount of time spent auditing the issue of withholding on nonresident employees who perform services both within and without New York. It should be noted an employer may withhold on nonresident employees who perform services both within and without New York based on an IT-2104.1, or based on adequate records. In the case of an employer who uses a time and attendance system for all or some of their nonresident employees who perform services both within and without New York the employer has chosen the adequate record method for the employees using the time and attendance system and should not accept an IT-2104.1 from these employees as it relates to income earned and paid in the current period.

Nonresident withholding on income earned in one year and paid in a later year: **Deferred Compensation, Stock Options and other income** – As stated previously, 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. This new policy also affects nonresident withholding on income earned in one year and paid in a later year. This new policy is effective as of the date of issuance of these guidelines, and should be incorporated into all open audits.

In determining the proper amount of wages subject to New York State withholding, an employer may rely on the guidance below for stock options, deferred compensation, bonus or any other income earned in one year and paid in a later year.

If all or part of the deferred compensation or stock option income that is considered wages for federal purposes are attributable to services performed in New York, the employer will be required to withhold on 100% of the compensation unless one of the following applies:

(1) The employee furnishes the employer with Form IT-2104.1 for the deferred compensation or stock options reflecting the proper allocation for the income; or

(2) The employer has an IT-2104.1 on record for the employee for the current year, and the employee is still being paid compensation for services currently being performed in New York State and the deferred compensation or stock option is less than $1,000,000 for the payroll period. In this case, the employer may withhold using the employee's estimated percentage of services performed for the current year; or

(3) The employee is no longer performing services in New York State or is no longer employed by the employer, and the deferred compensation or stock option is less than $1,000,000 for the payroll period. In this case, the employer may withhold using the employee's estimated percentage of services contained on the last IT-2104.1 submitted by the employee, in which the employee estimated a percentage of services performed in New York of greater than zero percent. (A prior IT-2104.1 submitted pursuant to (1) above for the specific purpose of withholding on deferred compensation or stock options will not be considered the last IT-2104.1 on file); or

(4) The employer has adequate records to determine the proper compensation amount from New York for the deferred compensation or stock options. In this case, the employer may compute the withholding based on that amount. The employer must maintain a record of how it computed the percentage of compensation subject to New York State withholding. Adequate records include but are not limited to IT-2104.1(s) on file for the entire compensable period.

For purposes of (1) - (4) above, the employer may rely on an IT-2104.1 submitted by an employee provided the employer does not have actual knowledge or reason to know that it is incorrect or unreliable.

In reference to number 4 above, in the case of deferred compensation or stock options, this would mean the employer would have to know the employees' percentage of services performed in New York for all years in which the deferred compensation or stock option were earned.
In the case of income subject to allocation based on Reg. Sec. 132.20, such as severance pay and other retirement benefits, the allocation percentage is generally based on the year of retirement and the three preceding years. Employers who maintain a time and attendance system[2] must withhold based upon option number 4 above or if the deferred compensation or stock option is less than $1,000,000 for the payroll period, the employer may elect to obtain an IT-2104.1 for the deferred compensation or stock options reflecting the proper allocation for the income, or withhold upon 100% of the compensation if all or part of the deferred compensation or stock option amount are attributable to services performed in New York.

The Nonresident Allocation Audit Guidelines contain a detailed discussion regarding the allocation of various types of compensation, and also contains information on which types of retirement payments made to nonresidents are not

2 A time and attendance system is a system where an employee on a contemporaneous basis records his work location for every day worked and the employer uses this data to allocate the employee's wages between all taxing jurisdictions in which the employee performs services.

considered New York source income. For example, federal legislation passed in 1996 made most forms of retirement pay received by nonresidents not taxable.

TSB-M-95(3)I contains a detailed discussion on the proper sourcing of stock based compensation.

Examples

Example 1. Employee H is a nonresident of New York and retires on 12/31/2001. On 3/1/2002 Employee H exercises nonstatutory stock options resulting in $400,000 in wage income. Employee H has always been assigned to the New York office and has performed over 90% of his services in New York. On January 2, 1999 Employee H submits an IT-2104.1 to his employer estimating the percentage of services performed in New York as 90%. On 3/1/2002 Employee H submits a separate IT-2104.1 to his employer for the purposes of withholding on his stock option income. The submitted IT-2104.1 shows a 10% New York allocation percentage. The employer may not rely on this IT-2104.1 since the employer has actual knowledge it is not correct. If the employer were to accept the IT-2104.1 and withhold on 10% of the stock option income, the employer would be liable for any tax, penalty or interest on Employee H’s under withholding. The employer may withhold based on the last IT-2104.1 submitted by Employee H on January 2, 1999.

Example 2. Employee J is a nonresident. On January 2, 2002 Employee J submitted an IT-2104.1 to her employer showing an estimated percentage of services performed in New York of 80%. During tax year 2002, Employee J is paid a regular salary of $200,000 which is paid in 2002 and earns a bonus of $100,000 which will be paid on February 1, 2003. During 2002, the employer withholds on Employee J’s regular salary based on the estimated percentage of 80% shown on the IT-2104.1. On January 2, 2003 Employee J submitted an IT-2104.1 to her employer showing an estimated percentage of services performed in New York of 20%. The employer accepts and relies on the IT-2104.1 and does not have actual knowledge or reason to know that it was incorrect or unreliable. On February 1, 2003 the employee is paid the bonus earned in 2002 of $100,000. Employee J does not file with her employer a separate IT-2104.1 for the bonus amount. The employer may withhold using the 20% for the $100,000 paid in 2003. When Employee J files her IT-203 for 2003 she would be required to allocate the $100,000 bonus using her actual allocation for the 2002 year because that is the year in which the bonus was earned.

Example 3. Employee K is a nonresident and earns a regular salary of $800,000 in tax year 2003. The employer has on file an IT-2104.1, dated January 2, 2003, with an estimated percentage of services performed in New York of 20%. The employer had no actual knowledge or reason to know the percentage shown on Form IT-2104.1 was incorrect or unreliable. The employee exercises nonstatutory stock options and receives $4 million in wage income. The employee does not submit a separate IT-2104.1 for the stock option income. The options were granted on 1/1/1998 and were exercised on 12/31/2003. For the years 1998-2002 the employee worked 80% of the time in New York. On 1/1/2003 Employee K was transferred to the employer’s Massachusetts office. For 2003 Employee K’s actual percentage of services performed in New York was 20%. The employer may not withhold on only 20% of the $4 million stock option income earned in the last payroll period of 2003, since the stock option income exceeds $1,000,000 for the payroll period. If the employer were to withhold based on the current IT-2104.1 the employer would be responsible for any tax, penalty, or interest on employee K’s underwithholding.

Since a portion of the stock option was connected to services performed in New York, the employer would be required to withhold on 100% of the $4 million stock option payment unless it had adequate records to determine the proper amount of stock option income attributable to New York. In this case, the amount of stock option income attributable to New York would be calculated based on the compensable period. Assuming Employee K worked the same number of total days in each year from 1998 through 2003, the percentage of the stock option that would be New York source wages would be 70% ((80+80+80+80+80+20)/6) of $4 million, which is $2.8 million. If the employer withheld on only 20% of the $4,000,000, which is $800,000, the underwithholding from the $2,000,000 of stock option income not withheld on would be the responsibility of the employer.

Nonresident withholding on wages earned in one year and paid in a later year: Audit process - wages from the exercise of nonstatutory stock options tend to be very large and in some cases can run in to the tens of millions of dollars. As shown in the example above, the method of withholding by the employer can lead to very different amounts of withholding. The auditor needs to carefully examine withholding on employees who exercise nonstatutory stock options and who have less than 100% withholding. The auditor should also determine which method of withholding was used: current IT-2104.1, IT-2104.1 submitted specifically for the stock option, last IT-2104.1 submitted or employer calculation of the withholding percentage. As stated above, if the employer uses the current IT-2104.1 or the last IT-2104.1 submitted to withhold on the stock options (if they are under $1,000,000 in a pay period) there is a possibility the employee will have withholding that is far less than the tax liability on their individual return. If this method is used, the auditor should review the employee's IT-203 to see how the employee allocated the stock option income to New York. Then, if the allocation appears incorrect, an individual audit case should be created. A similar type of analysis should also be conducted when withholding is based on the other allowable methods, depending on the wage amount involved and the percentages used. Auditors should verify employers are consistently withholding on wages earned in one year and paid in a later year of under 1 million dollars.

Information that might help the auditor determine if individuals correctly allocate stock option income include: prior year tax returns, prior year wage reporting information, schedules attached to the current year tax return, and information obtained from the employer.

It should be noted that, for nonresident high wage earners with no New York State nexus who appear on EDP report 3-2 and who have income from stock options, if all or part of the days worked in the compensable period (the grant to exercise date) were worked in New York, the employer could be responsible for tax, penalty and interest on 100% of the stock option income. This is because employees on this report should have no withholding and one would expect in most cases no IT-2104.1 will be on file. The employer would not be responsible for withholding on 100% of the stock option income if the employer had the records available to calculate the actual percentage of time worked in New York during the compensation period. The employer would be responsible for tax, penalty and interest based on the actual percentage of time worked in New York during the compensable period.

The principles above could also be applied to other forms of compensation earned in one year and paid in another, for example, deferred bonuses, severance pay, etc. For further information regarding the proper sourcing of the various types of compensation an employee can receive, please refer to the Nonresident

Allocation Guidelines. It should be noted that certain types of payments received by nonresidents have been found to not be New York source income. As stated above, the Nonresident Allocation Guidelines provide guidance on these issues.

In situations where during the compensable period and in the year of payment an employee has worked a limited number of days in New York for each of these years the auditor should be reasonable when deciding whether to impose applicable tax, penalty or interest. If for example the employee worked nine days in New York during each year of the compensable period and nine days in New York during the year of payment, and there is no withholding from the employee’s wage, the auditor may decide it would not be reasonable to assess tax, penalty or interest against the employer for underwithholding on this employee.

Wages paid to nonresident employees who work in New York for 14 or fewer days -

Employers are not required to withhold on nonresident employees who are assigned to a primary work location outside of New York State and work in New York State 14 or fewer days in a calendar year. For the purposes of counting the days worked in New York State for the 14-day guidance, any part of a day spent performing services in New York counts as a full day. If an employee is not expected to work more than 14 days in New York State during the calendar year, but does in fact work more than 14 days in New York State, then the employer must withhold on New York State wages paid after the fourteenth day. If an employee is expected to work more than 14 days in New York State during the calendar year, the employer must withhold on all New York wages paid to the employee. When an employer claims that it did not expect an employee to work greater than 14 days in New York, but in fact the employee did work in New York for greater than 14 days, the auditor should inquire about the employee’s job title, the employee’s job responsibilities, and any other relevant facts in determining if the employer’s expectation was a reasonable one. It should be noted this guidance does not relieve employees from their responsibility to file personal income tax returns with New York State.

The 14-day guidance does not apply to payments made to nonresident athletes and entertainers performing services in New York State. For example, payments for services performed in New York by actors, singers, musicians, dancers, circus performers, writers, directors, producers, set designers, any other person appearing on television, radio, the stage, in a night club performance or hotel show, and payments to any person whose performance in New York is recorded or filmed. Other examples of these types of payments include payments to public speakers, wrestlers, boxers, golfers, hockey players, basketball players, football players, tennis players, baseball players and other athletes, as well as payments to referees, coaches and trainers. This withholding guidance is triggered by a performance in New York, rather than whether or where such a performance is broadcast into New York.

Additionally, the 14-day guidance will not apply to employees who receive income in the current year that is related to services performed in New York in prior years. For a further discussion of this subject see “Deferred Compensation, Stock Options and other income” above.

Example - Employee X is a New York State nonresident and an executive of Corporation Y which has its headquarters outside of New York State. Employee X travels to New York State once a month (12 days per year) to attend business meetings and has no other wages attributable to services performed in New York State. Because Employee X spends 14 or fewer days performing services in New York, Corporation Y is not required to withhold New York State personal income tax from the wages of employee X. However, Corporation Y is required to report Employee X’s wage information on Form NYS-45 or NYS-45-ATT, whichever is applicable, and in the State wages, tips, etc. box of federal Form W-2.

Example - Employee L lives in New Jersey and works in the New Jersey office. The employer does not expect Employee L to work more than 14 days during the calendar year in New York State. During the year the employee works in the New York office for 8 full days and 5 half days. The employee does not file an IT-2104.1 with his employer. Based on this information the employee would have worked in New York 13 days and the employer would not be required to withhold on this individual. Employee L would still be required to file an IT-203 to report New York source wages. However, if Employee L works in the New York office 8 full days and 7 half days, the employee has worked 15 days in New York, and the employer is required to withhold New York tax on New York wages paid for the fifteenth day only.

Wages paid to nonresident employees who work in New York for 14 or fewer days:
Audit process-In counting the 14 days, auditors should not count a reasonable number of training days/professional developments days.
Examples of training days/professional development days are for attendance at: in-house training courses, trade association conferences or symposia, professional development workshops or seminars and conventions.
Example- Employee Y is a nonresident and is assigned to a primary work location outside of New York State. Employee Y works 25 days in New York State. Fifteen of the 25 days are spent at an in-house training course. Employee Y has no New York Withholding. The auditor should not assess the employer for any tax, penalty or interest on Employee Y, since the 15 in-house training days are not counted against the 14 days.

Auditors should not assess any applicable tax penalty or interest resulting from underwithholding on a reasonable number of training/professional development days, for nonresident employees who are assigned to a primary work location outside of New York.
Example- Employee Z is a nonresident assigned to a primary work location outside of New York State. On audit it is determined Employee Z performed services as detailed below;

Days worked in primary work location state(Non-New York)	195
Days worked in New York in house training	15
Days worked in New York non-training	30
Total days worked	240

Employee Z’s withholding was based upon an estimated percentage of services performed in New York of 12.5%(30/240).
The auditor should not assess the employer for any tax, penalty or interest on Employee Z.

Auditors should not assess any applicable penalties against employers who do not report wages on NYS-45 Part C (columns d and e) or who do not report federal wages in the New York box on form W-2 for nonresident employees assigned to a primary work location outside of New York State who perform services in New York State and who meet the requirements of the 14 day guidance above.

Days Worked at Home and Telecommuting - Days worked at home by New York State nonresidents are usually considered to be days worked in New York if the employee's primary work location is in New York State. In general, if the employee is working at home for the convenience of the employee, as opposed to the necessity of the employer, these days will be considered days worked in New York State. However, if the employee does not enter New York State during the tax year, income tax withholding is not required.

As a result, the auditor should always inquire as to whether or not the employer has any employees that work at home. The rationale for this requirement can be found in Section 671 of the Tax Law. This section states that withholding from the employee's wages during the calendar year should be made in an amount substantially equivalent to the tax reasonably estimated to be due resulting from the inclusion in the employee's New York adjusted gross income or New York source income of his wages received during the calendar year. Therefore, if the employee meets the conditions noted above, and the wages are considered New York State source income, income tax withholding is required.

The auditor may refer the employer or representative to TSB-A-96(10)I regarding the issue of days worked at home. This Advisory Opinion notes that regardless of whether certain functions of employment take a taxpayer outside New York, the work sought to be allocated must be performed away from the employer's New York office due to the necessity of the employer. Since the nature of the services in the Advisory Opinion did not require that they be performed outside the New York City office, the Petitioner was not allowed to allocate the days he worked at his Connecticut home office as days worked outside New York State for wage allocation purposes.

For further guidance and cases regarding the personal income tax ramifications of this issue, the auditor should refer to the Nonresident Allocation Guidelines.

6) DETERMINING TAX TO BE WITHHELD ON WAGES PAID TO NEW YORK CITY RESIDENTS AND NEW YORK CITY NONRESIDENTS

NEW YORK CITY RESIDENTS

According to the city of New York Administrative Code, Section 11-1771, if an employer maintains an office or transacts business anywhere in New York State or New York City, the full amount of the city of New York resident tax is required to be withheld for employees who are city of New York residents, regardless of where the employee actually worked. This includes all employers conducting business in New York State, even though the employer may not conduct any business in the city of New York.

Example 1: an employee lives in New York City, works in neighboring State C and earns $100. The withholding tax rates in New York State and State C are 7% and 5%, respectively. The withholding tax rate in New York City is 4%. There should be $5 income tax withheld for State C, $2 withheld for New York State, and $4 withheld for New York City.

Example 2: an employee lives in New York City, works in a New York State county that is outside New York City, and earns $100. The employer does not conduct business in New York City. There should be $7 income tax withheld for New York State, and $4 withheld for New York City.

City of New York resident zip codes: Some employers with payroll departments located outside New York State should be aware that the city of New York includes five boroughs: Manhattan, Queens, Brooklyn, Staten Island and The Bronx. Furthermore, Queens consists of many towns of which the employer should be aware are located in the city of New York, such as Flushing, Forrest Hills and Kew Gardens.

NEW YORK CITY NONRESIDENTS

Prior to July 1, 1999 - the New York City nonresident earnings tax was equal to .0045 (or .45%) of wages earned in the city of New York.

Effective July 1, 1999 - the New York City nonresident earnings tax was repealed. There is currently no earnings tax on wages earned by New York City nonresidents working in New York City.

7) DETERMINING TAX TO BE WITHHELD ON WAGES PAID TO CITY OF YONKERS RESIDENTS AND CITY OF YONKERS NONRESIDENTS

YONKERS RESIDENTS

All wages paid to a Yonkers resident are subject to personal income tax withholding even though the services may have been performed outside Yonkers. The Yonkers resident tax is equal to a percentage of the New York State tax. Publication 647, City of Yonkers *Addresses for Collecting and Reporting Sales Tax* can be used *to determine addresses in the City of Yonkers.*

YONKERS NONRESIDENTS

An employee who is not a Yonkers resident but performs services in the city of Yonkers must complete and give the employer Form IT-2104.1, *New York State, City of New York, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax*, certifying Yonkers nonresidency. The Yonkers nonresident earnings tax is withheld on wages paid to Yonkers nonresident employees for services performed in Yonkers. If the total wages for services performed in Yonkers is expected to be $3,000 or less withholding is not required.

8) EXEMPTION FROM WITHHOLDING

Regulation 171.8 states that an employer need not deduct and withhold any New York State personal income tax from a payment of wages made to an employee provided the employee furnishes the employer with a completed *Certificate of Exemption from Withholding, Form IT-2104-E*, (**Form IT-2104 may not be used**) certifying that the employee qualifies for exemption from withholding of New York State personal income tax.

Tax Law section 671(a) (3) exempts employees under age 18 or over age 65, or full-time students under age 25, who had no New York income tax liability in their previous taxable year and expect none in the current year. **Employees must file Form IT-2104-E annually if they wish to continue the exemption. federal Form W-4 is not acceptable to claim exemption from New York State Withholding.**

Under certain circumstances, the exemption from withholding is required to be revoked by the employer or employee (these conditions are listed on New York State Form IT-2104-E). In addition, if an employee claims exemption on NYS Form IT-2104-E and usually earns more than $200 per week, **the employer must send Form IT-2104-E to the Tax Department** along with a copy of any written statement received from the employee that supports the claims made on the certificate.

As with the Form IT-2104, the auditor may also request verification of the submission of Form IT-2104E to New York State. All requests should be made through Field Audit Management, and require the tax year Form IT-2104E was sent to New York State, the tax years under examination, employer name, employer identification number, employee name and employee social security number.

9) OTHER WITHHOLDING ISSUES

Voluntary Withholding Agreements - Under Regulation Section 171.7, an employee and his employer may enter into an agreement to provide for withholding of New York State personal income tax upon payments made as remuneration for services performed by an employee for his employer which do not constitute wages pursuant to section 171.3 of the New York State Regulations, but which are included in the New York adjusted gross income of the employee. Such an agreement must be applicable to all such amounts paid by the employer to the employee.

For example: an employee lives in New York State and works in another state. The employer does not maintain an office or transact business in New York State. The employee may request that the employer withhold New York State tax from wages. The amount that the employee would request be withheld would most likely be equal to the difference between the New York State resident tax rate and amount required to be withheld for the work state. Otherwise, the employee would be required to file estimated taxes with New York State. The employee would then claim a resident tax credit on his or her personal income tax return.

The employee must agree to the withholding, subject to termination on written notice by either party. The furnishing of Form IT-2104 constitutes a request for withholding. If the employee is subject to withholding on the payment of wages by his or her employer, the employee may also enter into an agreement with his or her employer for withholding on payment for services not considered wages by furnishing the employer with a written request containing his or her name, address, social security number, statement that he or she desires withholding and the duration of the withholding.

Interstate Carriers and seamen engaged in all types of trade - Regulation Section 171.3(2) states that the term wages, for purposes of withholding New York State personal income tax, does **not** include:

i) compensation paid to an officer, master or any other seamen who is a member of the crew on a vessel engaged in foreign, coastwise, intercostal, interstate or noncontiguous trade;

ii) compensation paid by an interstate rail carrier, an interstate motor carrier or an interstate motor private carrier to an employee who is not a resident of New York State for income tax purposes under section 605(b)(1) of the Tax Law, for performing such employee's regularly assigned duties in two or more states even though the employee performed services in New York State;

iii) compensation paid by an interstate air carrier to an employee who is not a resident of New York State for income tax purposes under section 605(b)(1) of the Tax Law, for performing such employee's regularly assigned duties on an aircraft in two or more states unless such employee earns more than 50 percent of such compensation in New York State. An employee shall be deemed to have earned more than 50 percent of their compensation in New York State when the employee's scheduled flight time in New York State is more than 50 percent of the employee's total scheduled flight time in the calendar year employed.

See TSB-M-91-(5)I for additional information on interstate carriers.

Please note that, although there is no New York State withholding tax requirement for employees that meet these criteria, the auditors should still conduct a test verification in order to determine that the individuals filed personal income tax returns with New York State. Then, if the auditor finds nonfiling individuals, a referral to the Income Franchise Desk Audit Nonfiler Unit should be made.

Supplemental Unemployment Compensation Benefits - Regulation Section 171.9 addresses the withholding of New York State personal income tax with respect to payments of supplemental unemployment compensation benefits paid to an individual to the extent of the amount which is considered to be wages for federal income tax withholding purposes. Where wages are subject to allocation for purposes of withholding New York State personal income tax because a nonresident employee performs services within and without New York State, supplemental unemployment compensation benefits paid to such individual are also subject to allocation for purposes of withholding New York State personal income tax.

Annuity Payments (if requested by payee) - Regulation Section 171.10 states that any payment of an annuity made by a payer maintaining an office or transacting business in New York State to an individual, to the extent included in such individual's New York adjusted gross income, must be treated as if it were a payment of wages by an employer to an employee for a payroll period if, at the time the payment is made, a request that such annuity be subject to withholding of New York State personal income tax is in effect.

To qualify for withholding of New York state personal income tax, the annuity payment must be income to the recipient that would be includible in such recipient's New York adjusted gross income. Such annuity payment must also be payable over a period of longer than one year.

A request to deduct and withhold New York State personal income tax on annuity payments should be made by the payee by completing *Form IT-2104P, Annuitant's Request for Income Tax Withholding*. The request may be terminated by furnishing to the person making the payments a written statement of termination.

Nonresident Alien Employees Entitled to Tax Treaty Benefits - per Publication NYS-50, in accordance with Internal Revenue Service (IRS) guidelines, a nonresident alien employee who claims an exemption from tax under a provision of a federal income tax treaty must file with the employer a statement for the tax year giving the employee's name, address, and the taxpayer identification number and certifying that:

a) the employee is not a citizen or resident of the United States,
b) the compensation to be paid during the tax year is, or will be, exempt from income tax, and,
c) the reason for the exemption.

The statement should indicate the tax treaty provision, the country of which the employee is a resident, and enough facts to justify the claim for exemption. The statement must also:

1) be dated,
2) identify the tax year for which it applies and the pay to which it relates,
3) be signed by the employee entitled to the pay, and,
4) contain or be verified by a written declaration that it is made under the penalties of perjury.

A nonresident alien employee who claims exemption from tax in accordance with IRS guidelines is not required to provide any additional documentation to claim exemption from New York State and city income taxes. An employer may accept the statement submitted under federal guidelines. The employer is not required to submit the employee's statement to New York State but should maintain a copy of the statement submitted with the employee's records available for review by the Tax Department.

For more information on nonresident aliens and federal tax treaties, see federal Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*, and Publication 519, *U.S. Tax Guide for Aliens*.

III. ***THE AUDIT***

The Department of Taxation and Finance's purpose in conducting withholding tax audits is to verify that the correct tax was withheld and remitted in a timely fashion to New York State. As such, the employer is required to provide the auditor with records when requested to verify information on withholding tax returns submitted to New York State.

Throughout the course of an audit, the employer is to receive fair, courteous and professional treatment from the auditor. The auditor should only request information that is relevant to the audit, and should give the employer a reasonable amount of time to supply that information. Therefore, withholding tax audits should not include a year where the statute of limitations will be expiring within four months from the date of the appointment letter.

In addition, the auditor should not close a case as disagreed because the statute of limitations is expiring and the employer is still gathering information for review. Instead, when possible, the auditor should obtain a waiver to extend the statute of limitations.

1) PRE-AUDIT ANALYSIS

Prior to the mailing of the appointment letter, the auditor should complete a thorough analysis of the employer in order to identify potential audit issues. The easiest and most comprehensive manner in which this can be accomplished is through analysis of the various information available to the auditor on the Tax Department's computer system.

If there was a prior withholding tax, corporation tax or flow through entity audit conducted on the employer, then the auditor should request the file from the district office that completed the audit. The file should then be reviewed prior to the issuance of the audit appointment letter. This will prevent issues previously addressed and analyzed from being duplicated (i.e. subcontractors, high wage earners with no NYS nexus), unless the circumstances involving the corporation or issue have changed.

The auditor should also verify whether there is an <u>open</u> corporation tax or flow through entity examination currently in progress. If an open case exists, the auditor should then contact that auditor and inquire as to the scope of the withholding tax review. The withholding tax or business tax case should then be either transferred to one office or should be worked in unison with the other audit team, as deemed appropriate by district office management staff. In either event, the withholding tax and business tax cases should be worked in conjunction with one another to reduce the burden on the business and as much as possible reduce or eliminate the need for taxpayers to respond to multiple requests to provide the same records.

The auditor can also request the corporation or partnership tax returns through Tax Department resources before requesting additional documentation in the appointment letter. This will enable the auditor to ask more specific questions prior to the audit appointment or request additional information not usually present in standard appointment letters.

In summary, during the pre-audit analysis the auditor should try to:

- determine how the business operates
- identify which business functions are carried on in New York
- establish the type of business operations carried on outside New York
- ascertain total number of workers employed within and outside New York

Sources of information and available tools include:

- various Tax Department data obtained from mainframe computer system Withholding Tax Employer Profile Data Sheet, Form AU-347 (*Withholding Tax Screening Sheet*), and/or Form AU-440 (*Withholding Tax Issue Identification Worksheet*
- allocation factors on the New York State business tax return (New York and everywhere)
- conversations with prior auditors who have completed corporation tax audits and withholding tax audits
- Internet research, such as employer website and Mergent online
- Closed case files
- Current open audits

- LexisNexis

2) AUDIT APPOINTMENT

The initial request for information is conducted through either an appointment letter or telephone call. In most cases, this letter will be a form letter requesting the information needed to be reviewed at the audit. This letter should be drafted to suit each employer based on the pre-audit analysis. For example, if the employer is a non-filer, the appointment letter or phone contact should also include a question asking for an explanation. In this instance, it may not be necessary to review numerous documents when the employer may no longer be in business.

The appointment letter or confirmation letter usually includes a description of the books, records and other related documentation which will be necessary for the audit to be completed. The letter may also include a date specifying when and where the audit will be taking place and should be sent to the taxpayer at least thirty days prior to the start of the audit. Proper scheduling of audits will afford the employer a reasonable time to assemble the required accounting records and should aid in reducing a request for postponement of the start of the audit.

The appointment letter should always contain two enclosures. The first is a blank power of attorney, which will enable the employer to appoint a representative to discuss the case. The second is Publication 130-F, "*The New York State Tax Audit - Your Rights and Responsibilities*," which clarifies some important questions that the employer may have. Publication 130-F is especially vital due to the information contained within that describes what the taxpayer should expect during the course of a field audit in addition to the mechanics of the appeals process.

1. **SCHEDULING THE AUDIT** - Auditors are encouraged to arrange their schedules with the employer, or the representative, in such a manner as to spend a sufficient number of consecutive days at the audit site to complete the audit without having to make return visits. Additional information clarifying an issue or substantiating expenses can be sent through the mail, if necessary.

The auditor should always confirm the appointment by telephone prior to the field visit. This will give the auditor the opportunity of asking questions concerning the type of business, and also affords a more thorough discussion with the taxpayer concerning the records that will be required for the audit. However, at no time should the auditor attempt to verify documents or figures over the telephone. A withholding tax audit cannot be performed by telephone.

The auditor should schedule the audit at the employer's place of business. However, if the auditor must conduct the audit at another location, the auditor should also visit the place of business. This will afford the auditor a chance to become more familiar with the employer's business and may help to identify the course the audit should take.

2. **POSTPONEMENTS** - If the employer requests a delay, a reasonable period, generally thirty days from the originally proposed starting date, should be allowed. Postponements for more than thirty days should be requested by the employer in writing, setting forth the reasons and advising of a date when the

records will be available for review. (**NOTE**: When the employer requests a postponement for any length of time, the auditor may need to request the employer to extend the statute of limitations.)

3. **NO RESPONSE** - If the auditor does not receive a response from the employer or representative within the first three weeks after the appointment letter is mailed, the auditor should attempt to verify by telephone that the employer is still in business. The auditor should then send a "Second Request" for information by certified mail with a "return receipt requested" to the employer's last known address.

If there is still no response from the employer, a visit may be necessary to the last known address to see if the employer is still in business. If the auditor visits the business location and has contact with the employer, a decision will then have to be made as to whether a withholding tax field audit should be conducted. As a result of the site visit, the auditor may decide to discontinue the audit based on discussions with the employer as well as through personal observations. In this situation, instead of providing the business with a No Change letter, the auditor should issue a Letter of Discontinuance.

The auditor should also search the Tax Department's computer system, check the local phone book and search an address directory to see if the employer is listed at any additional addresses, and then contact them by phone if possible. These types of searches can also be conducted with the assistance of an Audit Investigator.

All District Offices should have an Audit Investigator assigned to one of the tax sections. Although the Audit Investigator may not be physically assigned to a unit where withholding tax audits are conducted, the Audit Investigator is available for use by all audit staff within that District Office.

The Audit Investigator has received training in various types of investigative work and is a valuable asset to the Tax Department. The Audit Investigator can visit known addresses and make inquiries in order to identify the current status of the business (for example, bankrupt, out of business, moved, etc.). The Audit Investigator can also attempt to obtain any potential new addresses for the business as well as attempt to identify the names and addresses of potential responsible persons. As a result, the Audit Investigator should be utilized when the auditor either cannot locate the business through the above noted procedures, or, if other commitments prevent the auditor from the opportunity to complete a timely determination as to the current status of the business under audit.

If the employer or the representative notifies the auditor that the employer is no longer in business, the auditor should request verification. If the employer is in fact out of business, the auditor should then make a determination if they should continue the audit based upon the pre-audit analysis.

If the audit seems worthy, the auditor should complete the audit even if the company is out of business. Here, the auditor should utilize all available information in order to create an accurate assessment and should identify all responsible individuals. If the auditor determines that the employer is out of business, and the audit does not seem worthy, the auditor should then close the case without audit, and **not** as a no change. Again, as noted above, if the auditor has had contact with the business or representative, instead of providing the business with a No Change letter, the auditor should issue a Letter of Discontinuance to the employer.

4. **OPENING INTERVIEW** - It is important that the auditor conduct a thorough opening interview. Some of the questions that should be asked are as follows:

- what the business does and how does it operate?
- location and types of various business activities conducted both within and without New York State.
- how the business withholds on nonresident employees working in New York State.
- how the business withholds on residents working outside New York State.
- who are the persons responsible for withholding and submitting personal income tax to New York State?

In short, an understanding of how the business operates is vital to the audit process. In addition, the questions asked at the opening interview should be modified based on the business under audit. For some additional guidance regarding the opening interview, the auditor may also refer to the section of the guideline regarding the High Wage Earner issue.

3) RESPONSIBLE PERSONS

It is imperative that all auditors identify and record in their field audit report all of the individuals responsible for reporting and remitting the income taxes withheld. This procedure is mandatory, and must be accomplished whether the auditor may or may not recommend an assessment against the employer or a responsible individual. As a result, this will ensure that the Tax Department, if necessary, will be able to issue responsible person assessments on the appropriate individuals.

It is essential that all auditors also identify and record in their field audit report the reasons for either assessing or not assessing responsible persons. The 685(g) penalty, or responsible person assessment, is on an individual, and is created in addition to the assessment issued to the entity under examination. Therefore, it is vital that a detailed explanation is documented by the auditor as to the rationality applied in determining the identity of the responsible persons. This is especially crucial during the appeals process, and is extremely useful during review of informal protest materials received from individuals identified by the auditor as responsible persons.

A valuable aid available for use in determining responsible persons is the *Withholding Tax Responsible Person Questionnaire* (see Appendix A). This form is available in both a short version (AU-434-S) and a long version (AU-434-L). These forms were created specifically for income tax field auditors and are an integral part of the auditor's workpapers. Although it is the auditor’s decision as to which of these forms should be utilized, at least one should be completed at the start of most withholding tax field audit examinations.

If the employer is uncooperative or cannot be located, the auditor should use other means in an attempt to identify the responsible persons of the business. Various sources that can be utilized by the auditor are contained on the Income Tax Reference Page, listed in multiple documents under the section titled *Withholding*.

Responsible person assessments should only be issued on unpaid cases (agreed or disagreed) where there is a reasonable indication that collection of the tax liability is questionable as indicated by financial factors, or if the business is to be (or has been) sold or dissolved.

Some of the financial indicators to consider include, but are not limited to, the following:

- filing and payment record;
- cash flow problems;
- pending lawsuits;
- bankruptcy or restructuring proceedings;
- any other condition(s) which may jeopardize the payment of withholding taxes due.

The auditor should issue all responsible person assessments through Field Audit Management via electronic mail. (NOTE: Responsible person assessments cannot be issued when the employer is assessed only penalty and/or interest).

Please refer to Section IV of these guidelines, *Additions To Tax and Civil Penalties, Section 685(g) Penalty*, for additional information regarding the identification and assessment of responsible persons.

4) BOOKS AND RECORDS

It is important that the employer and/or the representative is fully aware of the information that will be required for the audit. The term "books and records" has different meanings to various people. Therefore, the auditor should always be as specific as possible when requesting books and records that will be reviewed. Also, the employer should be alerted that additional records may be requested during the course of the audit based upon the direction that the audit takes.

General requests for information can be found in standard appointment letters to the employer. However, auditors should remember to adjust their requests for information based upon specific records needed for each individual audit due to the type of industry in which the employer operates and the results of the auditor's pre-audit analysis.

The best means in which the auditor may accomplish this initial request for information is to first complete a thorough pre-audit analysis. Then, the auditor should have a conversation with the taxpayer/representative. This will allow the auditor to be more forward in his/her request for records, and will help point the audit in the appropriate direction.

Some of the New York State and federal documents that will normally be requested and reviewed in each audit include the following forms:

NYS-1 New York State Return of tax withheld

NYS-45 New York State Quarterly Combined Withholding, Wage Reporting, and Unemployment Insurance Return (reconciles tax withheld made on Form NYS-1)

NYS-45-ATT	New York State Quarterly Combined Withholding, Wage Reporting, and Unemployment Insurance Return - Attachment (reports employee’s wages and w/h)
941	Federal Quarterly Reconciliation of Tax Withheld
940	Federal Reporting of Unemployment Tax
W-2	NYS and Federal Employee Wage and Tax Statement
W-3	Transmittal of Wage and Tax Statements (W-2 summary totals)
IT-2104, W-4*	NYS and Federal Employee's Withholding Allowance Certificate
IT-2104.1	New York State, City of New York, and City of Yonkers Certificate of Nonresidence and Allocation of Withholding Tax
1099-MISC	Federal Non-employee Miscellaneous Income Statement
1096	Annual Summary and Transmittal of U.S. Information Returns (includes 1099-MISC summary totals)
CT-3, CT-4	NYS Corporation Tax Return
CT-3-S, CT-4-S	NYS S Corporation Tax Return
1120, 1120S	Federal Corporation and S Corporation Tax Return
IT-204, 1065	NYS and Federal Partnership Tax Return
1040 Schedule C	Sole Proprietor Tax Schedule

* In most instances, the auditor will not be reviewing the above noted Form IT-2104. Instead, employers will usually supply federal Forms W-2 and W-4 for review because these records are usually acceptable for New York State withholding tax requirements.

In addition, when appropriate, the auditor should also request and review the **general ledger, payroll register, Certificate of Incorporation**, and **job contracts with subcontractors.**

It is possible that the employer’s records may be maintained in computerized form. In these situations, the auditor may still request paper records be supplied, if the request is not burdensome. However, if the business employs a large number of workers, the auditor should request computer assistance from the Tax Department's Electronic Data Processing (EDP) unit.

It is important that EDP assistance be utilized whenever possible. In general, large employers use computers to store payroll information electronically. If the employer maintains electronic payroll records the auditor should do what he/she can to utilize these records and limit the burden on the taxpayer of supplying paper information.

During Computer Assisted Audits, the EDP unit aids the auditor in gathering and organizing employer records with the use of electronic information. Through the manipulation of electronic data and various sampling techniques, the EDP auditors reduce the onus on both the employer and the auditor.

In addition, Computer Assisted Audits are an excellent method for the auditor to utilize because the audit should be completed in substantially less amount of time than it would have taken otherwise. Also, ideas and issues that may have previously gone unexplored due to the amount of work that would have been involved by the auditor can now be examined in great detail with relative ease. Thus, EDP assistance, when appropriate, should facilitate withholding tax examinations and provide more accurate and timely results. If an auditor feels that EDP assistance may be warranted, his/her supervisor should contact Field Audit Management for details.

5) AUDIT GOALS AND ISSUES

As in any audit, the main goal is to verify that the amounts reported and remitted on the tax returns are correct. Specifically, the main goals of the auditor during a withholding tax audit are to ensure that the employer is:

1. computing and remitting the proper amount of withholding tax due,
2. following proper filing requirements, and,
3. correctly classifying the proper individuals as employees.

Whenever feasible, the withholding tax audit period should be brought up to and include the last quarter filed by the employer.

The auditor should also be aware that there may be additional affiliated entities for which payroll should be reviewed. This issue may be important when attempting to reconcile federal taxable wages on the W-2's to the business tax returns (941, 1065, 1120, NYS-45-ATT, IT-204, CT-3, etc...). Based on this analysis, the auditor may then choose to review additional employers in order to conduct a complete withholding tax audit of the original entity under examination.

In order to satisfy each of the audit goals as described above it is the auditor's responsibility to use various audit techniques and procedures during the course of the audit. In addition to completing the pre-audit analysis as described previously in these guidelines, the most prevalent and productive methods that should be utilized to document that the employer has accounted for the proper amount of wages and to determine that a sufficient amount of tax has been withheld and submitted to New York State include the verification of wages, and a review of the W-2's, payroll register, and general ledger.

The third goal of ensuring that the employer has properly classified all independent contractors involves a review of form 1099's, and is discussed in the next section. Then, if after a review of all the requested records the auditor determines that an assessment will be issued, the employer should go through the AU-7 process and the auditor will compute the tax due and issue a Statement of Withholding Tax Audit Changes.

Verifying Wages and Taxes Paid - In every audit, the auditor should compare the amount of wages reported on the employer's wage and tax statement to the employer's corporate, partnership or sole proprietor tax returns. Wages to employees may be reported and are commonly found in some or all of the following areas of the employer's tax return:

Compensation of Officers
Salaries and wages
Cost of goods sold
Subcontract expense
Consulting expense
Other Expenses

If the wages on the tax return do not agree with the New York wages reported on the W-2's the auditor should always identify the reason and reconcile the difference. Some typical explanations include: accrual basis, fiscal year, deferred compensation, or missing wage and tax statements.

a) Accrual Basis - May arise when a taxpayer accounts for an expense on the tax return that was not actually paid. For example, if a calendar year taxpayer has a monthly payroll that ends 1/15 of the following tax year, this means that the employees were not actually paid for the period 12/15 through 12/31. Since these workers were not paid until 1/15 of the following year, none of the wages earned from 12/15 through 12/31 will show on the employee W-2's. However, the calendar year accrual taxpayer will account for that salary expense and will include it on their general ledger and tax return for the amount of wages from 12/15 through 12/31.

b) Fiscal Year - Usually occurs when an employer uses a fiscal year on the tax return because it coincides with their general ledger accounting. Since the W-2's are submitted on a calendar year basis, the wages and compensation on the tax return will not reconcile with the total wages on the W-2's. In these instances, the auditor should reconcile the tax return to the general ledger. Then, the general ledger wage amounts should be calculated over the calendar year and should reconcile to the total wages on the W-2's.

c) Deferred Compensation - Items such as accumulated sick leave and vacation leave, or stock option plans may be included in wages and compensation on the tax return and not included on the employee W-2's. If material, the auditor should explore these areas and verify that the compensation paid should not have been included as federal taxable wages on the employee W-2's.

d) Missing Wage and Tax Statements - The auditor should be aware of the existence of subsidiaries or other divisions of the entity that are accounted for under another employer identification number. Also, W-2's may not have been provided because they are simply in another box or are located at another site, such as storage in a warehouse facility. Here, a quick reconciliation from the tax return to federal Form W-3 should identify any potential issues.

If the tax return wages are greater than the wage statement returns, and the employer cannot account for the difference, it may be possible that there were wages paid for which there were no withholdings. For example, year end bonuses with no withholdings may be the cause for the two numbers not reconciling.

In some cases the auditor may be examining an employer with workers in various locations. Here, reconciling the tax return wage amounts to the New York wage amounts may not be possible. In these cases, the auditor should instead reconcile the general ledger New York wages and compensation paid to the New York W-2 amounts. In addition, W-2 summary sheets may not be available or total New York wages may be difficult to calculate. In these instances, the auditor may use the NYS-45 or NYS-45-ATT to obtain total New York wage figures.

Other documents that should be reviewed for the purpose of reconciling New York State wages and taxes include the employer's NYS Forms NYS-1, New York State Corporation, S Corporation or Partnership returns, and federal Forms 940 and 941.

1) NYS Form NYS-1 and NYS-45 - The auditor should review these forms during the course of the audit to ensure that the employer has submitted all NYS-1 and NYS-45 payments to the Tax Department. All NYS-1 amounts should then be reconciled to Tax Department records and to the employer's NYS-45 quarterly tax returns. If the employer has not retained these forms and there is no record of the employer submitting withholding taxes to New York State, the auditor should review the employer's canceled checks and then search the Tax Department records using the "DSN" that should be printed on the canceled check.

2) NYS Corporation (CT-3 or CT-4), S Corporation (CT-3-S or CT-4-S) and Partnership (IT-204) returns - When these returns are submitted, the employer is sometimes required to compute a Business Allocation Percentage based upon three factors. This three factor calculation is included in the attachments to the tax return and one of the three factors is for New York State payroll amounts of "wages and other compensation of employees except general executive officers." Although officer salaries are not included in this amount, this figure may present the auditor with an indication that there was additional New York payroll that the employer has not been reporting. The employer is not required to complete the three factor method when 100% of the employer's income is derived from NYS sources, which indicates that 100% of the employer's federal wages is from NYS employment.

3) Federal Forms 940 and 941 - These figures will more likely reconcile to the total W-2 wages issued by the employer because these forms represent federal wage figures for a calendar year period. The total number of employees nationwide can also be found on line 2 of the first quarter 941 return.

Reviewing W-2's - When the employees and their gross federal wages have been identified, the auditor should review all of the W-2's to ensure that a sufficient amount of New York State, New York City and Yonkers taxes have been withheld from the employee's wages. This should enable the auditor to identify individuals that had no New York State and local taxes withheld as well as those individuals that had an under withholding of New York State and local taxes during the period under audit.

If the W-2's are not complete or they are not available for review, the auditor may obtain New York W-2 salary and withholding information by reviewing the employer's fourth quarter wage reporting information (NYS-45 and/or NYS-45-ATT). It should be noted, however, that the wage reporting information may list only those employees reported by the employer as either living or working in New York, and may not be a complete listing of all employees working for the business. The auditor should then request W-4 and/or IT-2104 and/or IT-2104.1 forms for employees where there is an insufficient withholding of tax.

If the audit is conducted using EDP assistance, the business is requested to provide W-2 data for all employees nationwide. Information for all employees is needed in order to independently verify that all employees that require New York tax withheld are reviewed. All employees are also used to facilitate the reconciliation of the federal taxable wages submitted electronically during the audit to the federal tax wage information shown on Form 941. In addition, the employer is required to provide work location, home address, and other data that may be requested by the audit team.

W-4, IT-2104, IT-2104.1 and IT-2104-E - If the under withholding is due to more than ten exemptions claimed on federal Form W-4, the auditor may request substantiation that the W-4 was submitted to the Internal Revenue Service. One acceptable form of documentation would include copies of certified return receipts requested by the employer for the period in question. If the number of exemptions claimed for New York State is different than those claimed for federal purposes, Form IT-2104 must be completed by the employee.

If the under withholding is due to more than fourteen exemptions claimed on form IT-2104, it is required that Form IT-2104 be submitted to New York State. The auditor should then request the employer provide a copy of Form IT-2104 and request verification that this form was submitted to New York State. If necessary, the auditor may also request verification by special request through

Field Audit Management. Please see Section II, Part B(3), of these guidelines for additional information regarding Form IT-2104.

If the under withholding of tax is due to exempt status on the federal Form W-4, the employer must provide the auditor with a valid copy of NYS Form IT-2104-E, *Certificate of Exemption from Withholding* (Regulation Section 171.8). This form must be submitted to New York State every year if the employee usually earns more than $200 per week. All other Forms IT-2104-E should just be kept in the employers records. Employers are required to revoke a Form IT-2104-E if the employee no longer meets the age requirements during the course of the year for which the IT-2104-E was filed. The auditor can request verification of the submission of this form to New York State by special request through Field Audit Management. Please see Section II, Part B(8), of these guidelines for the NYS withholding tax exemption requirements.

If a requested form is not available for auditor review, and the submission of the form to the proper jurisdiction is in doubt, the tax should be computed as if the employee had zero exemptions (Federal IRC Section 3401(e)).

1. *Resident employees* - New York State withholding tax should be withheld on 100% of the wages paid to New York State resident employees working only in New York State. For New York State resident employees working outside New York State, refer to Regulation Section 171.5. Please also see Section II, Part B(4), of these guidelines for the withholding tax requirements on wages paid to NYS residents.

2. *Nonresident employees* – for discussion of withholding on nonresident employees, please refer to Section II(B), Part(5), of these guidelines.

High Wage Earners with low or no New York State withholding and New York State nexus - There are two classes of high wage earners: high wage earners who have a connection to New York on the payroll records (such as a New York work location or New York home address), and those who do not have a connection to New York on the payroll records.

If EDP assistance is utilized, any high wage earners with under withholding will appear on at least one EDP report. Employees with lower wages with under withholding will also appear on these reports. Depending on the number of exceptions on each report the audit team can examine all the exceptions. The exceptions can be stratified with the largest exceptions examined in detail and the rest of the exceptions can be examined based on sampling. This approach is most useful when a small number of exceptions account for a large percentage of the under withholding. If there is a large number of exceptions and none of the exceptions deviate much from the mean a test sample could be done for all the exceptions. A discussion with the taxpayer should take place as to the audit plan to be used.

It should be pointed out if the taxpayer requests a detailed audit or if you cannot agree on a test sample approach a detailed audit should be done.

It should also be noted that there could be valid explanations as to why there is under withholding. For example, since the EDP reports are run based on year-end data, if an employee moved or transferred into New York during the last month of the year, this may be a valid reason for the potential under withholding.

High Wage Earners with no New York State withholding and no New York State nexus – As noted above there are two types of high wage earners. The second type those who have no connection to New York on the company payroll records require a very different audit approach from the high wage earners who are connected to New York. The audit of the nonconnected high wage earners must be conducted in a reasonable manner taking into account how the business operates.

For EDP audits these individuals will appear on Report 3-2 (high wage earners with no New York connection). This report will generally only include the highest paid employees of the corporation. This report can be expanded based on the facts and circumstances of each case.

What follows are suggestions for how this issue should be developed during the audit. These are just suggested procedures and they should be modified based on the facts and circumstances of each case.

For suggestions for how this issue should be developed during the pre-audit phase, the auditor should refer to the recommended procedures as noted in the Pre-Audit Analysis section of these guidelines.

A thorough opening interview is also very important in the development of this issue. The auditor should consider asking some or all of the following questions at the opening conference:

- How does the business operate?
- What business functions are carried on both within New York and outside of New York?
- If corporate headquarters are located out of New York, are any divisions headquartered in New York?
- Do any other subsidiaries or affiliated entities conduct business in New York?
- Locations and functions of various business locations
- How often do employees travel to New York?
- Where do the employees stay while working in New York?
- Are there corporate apartments in New York? If yes, who stays there? Obtain log?

Audit procedures for after EDP report 3-2 (High wage earners with no New York connections) has been produced.

This report should be shown to the taxpayer. The taxpayer should be told this is a list of the highest paid employees who do not have a New York home address, a New York work location, or, New York wages. Basically these are people based on the information given to our EDP auditors who do not have a New York withholding requirement. The taxpayer should also be told that as part of our audit we verify the accuracy of their payroll system. In most cases the taxpayer should be asked to provide a list of the titles and work locations for the employees on report 3-2. The taxpayer should also be asked if any of these employees perform services in New York. If based on your conversations with the taxpayer and your knowledge of how the business operates, it does not seem reasonable that these high wage earners work in New York the examination of this issue should not continue.

Please note that EDP Report 3-2 should not be provided to the taxpayer unless presented for discussion purposes only. However, if the employer is uncooperative and will not provide information regarding this audit issue, prior to issuing an estimated assessment, the Section Head should call and write executives of the firm under audit (in addition to the representative) to inform them information has not been provided as requested. Under no circumstances should the employer be presented with a potentially substantial assessment prior to the review of the information. If attempts at obtaining information regarding this issue fail, the audit team should then contact Field Audit Management prior to issuing an assessment regarding the high wage earner issue.

If based on all available information the auditor believes high paid employees may be coming into New York to perform services, a small test sample should be selected and the taxpayer should be asked to provide documentation to show the employee's travel activities for a few months during the year. If possible, the sample employees should be selected based on information obtained through the auditor's pre-audit analysis and/or opening conference.

Documentation to be reviewed may include, but is not limited to, travel vouchers, expense accounts, calendars, airplane travel logs, credit card statements and/or corporate card accounts. Towards that end, an attempt should be made by the auditor to refine the request for information by asking the business their method of accounting for employee travel reimbursement

If it is found based on the test sample that high wage earners are coming into New York to perform services and the time spent in New York is more than 14 days, a discussion needs to take place with the taxpayer as to what will be the next step, such as projection of the error percentage found in the test sample, the selection of a larger test sample, or a detailed examination (if requested by the employer).

The preferable method is to audit a sample. While the taxpayer should be offered the option of a detailed audit, this should only be conducted when the taxpayer requests it, or if the auditor and taxpayer cannot arrive at an agreement as to a test sample method and the taxpayer appears to have significant non compliance problems.

If the employee works for 14 or fewer days in New York State and their primary work location is outside of New York State, the employee may not be subject to withholding. For a more detailed discussion of the 14 day guidance, please refer to Section II(B), Part(5), of these guidelines.

An employee who works 14 or fewer days in New York, but receives compensation related to services performed in New York in prior years (such as stock options or deferred compensation) will be subject to withholding. For the rules regarding withholding on income earned in one year and paid in a latter year, please refer to Section II(B), Part(5), of these guidelines.

In some instances a decision may be made to create individual audit cases on the high wage earner. If this decision is made the case should be created as soon as possible and the auditor should not wait until the withholding tax case is closed.

Corporate apartments - Auditors should always inquire with the employer as to the existence of corporate apartments. If the business owns or rents a corporate apartment in New York State, the auditor should determine who uses the apartment, as well as when and for what it is used. Not only could this line of questioning lead to potential withholding tax issues, the answers to these questions might lead to residency and/or wage allocation issues for individuals.

Payroll register - A review of the employer's payroll register is another method that the auditor should utilize in order to identify those individuals that had no New York State and local taxes withheld as well as individuals that had an under withholding of New York State and local taxes during the period under audit. Although an analysis of the W-2's or fourth quarter NYS-45-ATT may show sufficient withholdings for all workers, a review of the payroll register may reveal that certain salary payments made to individuals during the course of the audit period may have included low withholdings or show no withholdings.

A complete payroll register will provide a list of all workers for every payroll period, and will include salary and withholding information. The auditor should evaluate these entries for materiality, and should scrutinize the last several payroll periods for balloon payments and/or bonuses. For example, if an auditor discovers a salary payment at the end of a calendar or fiscal year with a large amount of withholdings, it may be possible that there were salaries paid during the year with little or no withholdings for which there should have been normal withholdings. In these instances, the auditor should assess any tax, interest and penalties that are applicable for the periods in which there should have been withholdings.

It should be noted that although a payroll company may be generating and creating the employer's withholding and payroll register information, the auditor must still conduct the audit and follow procedures in the same fashion. The employer under audit informs the payroll company of employee withholding exemptions and is still responsible for withholding and submitting the required taxes to New York State. Therefore, it is up to the auditor, not the payroll company, to verify that the correct amount of tax has been withheld and submitted.

General ledger - In conjunction with the payroll register, the auditor should also examine the general ledger "Loans and Exchanges" or similar accounts. This account will indicate a possible reclassification of officer or shareholder loans into payroll. For example, if according to the payroll register the officer or shareholder received little or no salary during the course of the fiscal year, and then received a substantial salary payment at the end of the year, it is possible that journal entries in the **"Loans and Exchanges" account** were in fact wages. Therefore, there should have been withholdings on the salary amounts in the "Loans and Exchanges" account, so the employer is liable for any tax, interest and penalties that are applicable. If the employer insists that these payments were loans, the employer must provide the auditor with a loan agreement showing the payment date due and/or the appropriate interest rate of the loan.

In addition, a review of the employer's New York State withholding tax returns should be completed. These records will indicate the payroll period (NYS-1), quarterly (NYS-45/NYS-45-ATT) and yearly (NYS-45/NYS-45-ATT) taxes withheld and submitted to New York State. These amounts should be compared to the corporation's general ledger and the Tax Department's records for accuracy, and any discrepancies should be explained. This will verify that all New York State taxes withheld were paid to New York State. Moreover, if the employer does not supply the auditor with these requested documents, the auditor must request the canceled checks to ensure that these amounts were paid.

Employer credit for taxes paid by employee (Form AU-7) - If the employer is unable to supply valid documentation for an amount of under withholding, the additional tax required to be withheld based on Regulation Section 171.4 should be assessed against the employer. In addition, interest and any applicable penalties should be assessed to the present date. If, however, the employer can obtain documentation proving that the employee has filed a New York State tax return and paid the additional tax due to New York State, the employer will be relieved of the tax only, but will still be liable for interest plus any penalties that may also apply.

The simplest and preferred method in which the employer can establish that an employee has filed a New York State tax return and paid the required taxes is to submit to the auditor a properly completed New York State Form AU-7 for each employee in question. In these instances, the auditor should provide a blank Form AU-7 to the employer for completion.

When a properly completed Form AU-7 is received, the auditor will give the employer credit for the tax paid for that specific employee only. Then, interest plus any applicable penalties would be computed through April 15th of the following year for that individual (NOTE: In addition, interest will continue to accumulate on the interest from April 15th to the current date). The employer will then still owe any tax, interest and penalty up to the present date for each employee where a properly completed AU-7 has not been submitted.

However, in certain situations, it may not be reasonable or practical for the employer to provide a completed Form AU-7 for every employee. In these instances, the auditor and employer may utilize alternative methods in order to reach the same audit goal, such as employing sampling techniques in conjunction with using Tax Department records in a manner as described below. Then, the terms of any agreed upon procedures should be documented in the auditor's field audit record.

For example, due to the nature of withholding tax field audits, an auditor may find that former workers may be difficult to locate, or that a large firm may find requesting Form AU-7 for each employee a substantial burden. Therefore, the auditor may agree to search Tax Department records for a sample of the employees in order to reduce the employer's responsibility of providing information, and may use the findings in order to make a projection.

Example 1: An employer that has recently stopped conducting business cannot locate the twenty individuals that had been working there during the tax years under audit. The total tax under withheld is equal to $50,000 for these twenty employees. The auditor and representative agree that the auditor will search the Tax Department records for only one of the tax years under audit and disclose the percentage of tax due for that tax year. As a result, the auditor discovers that four of the twenty employees did not file tax returns for a total of $5,000 in tax under withheld. Therefore, per the agreement, the auditor assesses tax, penalty and interest based on ten percent of the total tax liability for each year under audit.

Example 2: An employer operates a factory that averages 500 employees each year. However, many workers leave and are hired each year. The auditor and the employer agree to a sampling of twenty-five employees for only one of the tax years under audit. The total tax under withheld is equal to $80,000 for these twenty-five employees. The auditor and representative also agree that the auditor will review Tax Department records in order to determine if these individuals filed tax returns with New York State. As a result, the auditor finds that ten of the twenty-five employees did not file tax returns for a total of $40,000 in tax under withheld. Therefore, per the agreement, the auditor assesses tax, penalty and interest based on fifty percent of the total tax liability for each year under audit.

The auditor may also apply findings based on the sampling techniques of Tax Department records whether or not there is a final audit agreement. Accordingly, auditors may also employ this procedure and use their findings where the employer has been uncooperative, or a disagreement exists upon the discussion of the auditor's conclusion. In addition, the auditor should consider the possibility of using EDP assistance.

It is important to note that, when using the Tax Department's records as described in the above examples, due to the secrecy provisions of the Tax Law, the auditor is not permitted to disclose, specifically, which workers did or did not file a tax return with New York State.

These methods should be used for unusual circumstances encountered during the course of a withholding tax field audit, especially where a substantial burden would be placed on the employer to provide the requested Form AU-7's.

Computing audit tax due - When it has been determined that there will be an assessment issued and the employer has completed the AU-7 process as described above, the auditor must compute the tax due and issue a Statement of Withholding Tax Audit Changes. Here, the most preferable method to accomplish the calculation is to use the exemptions claimed on Form W-4 that were supplied by the employer during the audit for each worker in question. This would be especially favorable where there are only a few employees to consider.

If the employer does not provide the auditor with any of the requested W-4's, the auditor should consider all of the workers as one employee and compute the tax due based upon a single filing status with zero exemptions. This will be most common in situations where the auditor has reclassified independent contractors to employee status.

The actual calculation of tax due should be performed through the use of the Tax Department's Computational Withholding Tax computer application. This application is available to all auditors, contains all of the pertinent tax rates and is an accurate means of identifying the correct tax due on audit. It also provides the auditor with an important source of work papers and is a more efficient and effective use of the auditor's time.

In addition, the auditor should remember that, as mentioned above in the discussion of the AU-7 process, credit should be given on the Statement of Withholding Tax Audit Changes for the tax paid for all individuals that filed tax returns with New York State. Therefore, if all of the individuals in question filed tax returns with New York State, the employer will be responsible for only the interest and applicable penalties due through April 15 of the following tax year. Also, as mentioned above in the discussion of the AU-7 process, interest will continue to accumulate on the interest from April 15th to the current date.

6) RECLASSIFICATION OF INDEPENDENT CONTRACTORS

Employers decide whether to classify workers as independent contractors or employees. While both types of workers may provide similar services, employees do so under direct control of the employer. Conversely, independent contractors, organized as sole proprietorships, partnerships or corporations, provide services without the employer's direct control.

As a result, during the audit process the auditor should review 1099's issued by the entity. The auditor should then evaluate if workers receiving 1099's are properly classified as independent contractors because employers have economic incentives to misclassify. When employers classify employees as independent contractors, employers can reduce their tax liabilities by avoiding social security, unemployment and withholding taxes, as well as reducing their health insurance costs and avoiding contributing to tax qualified retirement plans. Other reasons for not treating workers as employees include costs associated with minimum wage laws, worker's compensation insurance and collective bargaining. As a result, workers misclassified as independent contractors incorrectly deduct business expenses not allowable to employees.

In order to properly evaluate the independent contractor issue the auditor should follow the same criteria that IRS examiners utilize for reclassifying workers. According to IRS Publication 15-A, *Employer's Supplemental Tax Guide*, this guidance includes the common-law rules which revolve around the degree of, or right of control an employer has over workers.

Common-law rules - To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories: **behavioral control, financial control, and the type of relationship** of the parties as shown below.

Behavioral control - Facts that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of -

Instructions the business gives the worker. An employee is generally subject to the business's instructions about when, where, and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.

Training the business gives the worker. An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

***Financial control* -** Facts that show whether the business has a right to control the business aspects of the worker's job include:

The extent to which the worker has unreimbursed business expenses. Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.

The extent of the worker's investment. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not required.

The extent to which the worker makes services available to the relevant market.

How the business pays the worker. An employee is generally paid by the hour, week or month. An independent contractor is usually paid by the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

The extent to which the worker can realize a profit or incur a loss. An independent contractor can make a profit or loss.

Type of Relationship - Facts that show the parties' type of relationship include:

Written contracts describing the relationship the parties intended to create.

Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

The permanency of the relationship. If you engage a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that your intent was to create an employer-employee relationship.

The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of your regular business activity, it is more likely that you will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

In determining the proper classification, the above factors can be extremely subjective. The auditor should keep in mind that each factor may or may not apply, and if a factor does apply its degree of importance can vary from occupation to occupation and with the related facts and circumstances.

Therefore, the auditor should weigh **all** of the above factors that apply to the employer under audit in order to determine the status of a worker or group of workers within a company. Here, the auditor may request the job contracts between the employer and worker in order to clarify many of the common-law rules. Furthermore, in situations where the auditor may need additional guidance beyond the common-law rules on a particular industry or type of worker, the auditor should conduct detailed research in order to achieve an informed decision.

One valuable source of research is ***Tax Management Portfolio No. 391 - Employee Defined***. This manual, published by The Bureau of National Affairs, Inc., lists numerous occupations and provides a detailed analysis of who is an employee for federal employment tax purposes, and emphasizes the difference between "employee" and "independent contractor." In addition, each analysis cites a corresponding Revenue Ruling, Court case or Regulation Section. This publication should be available for use in all district offices.

Another helpful source of research can be conducted through CCH online. CCH is available via the Intranet to all field audit staff in the district offices through the use of their individually assigned personal computers. CCH includes countless federal and New York State documents and case materials that are useful in examining employee versus independent contractor status issues.

In addition, although the auditor may simply inquire as to the nature of the common-law rules within a specific company, the easiest fashion in which to elicit a thorough response is to supply the employer with a blank IRS Form SS-8 for completion (see Appendix A). A properly completed IRS Form SS-8, *Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, will enable the auditor to review each of the common-law rules in detail and to make a more informed decision. **However, it should be clear to the auditor that no decision to reclassify workers should be based on only one or two factors.**

Corporate Officers - according to Section 3121(d)(1) of the Internal Revenue Code, the term employee also means any officer of a corporation. Therefore, all amounts shown on federal Form 1099-Miscellaneous as paid to a corporate officer should usually be reclassified to wages. One exception that might occur is if the 1099 payments were made for director's fees.

Industry Examples
The following examples may help the auditor properly classify workers.

Building and Construction Industry

Example 1. Jerry Jones has an agreement with Wilma White to supervise the remodeling of her house. She did not advance funds to help him carry on the work. She makes direct payments to the suppliers for all necessary materials. She carries liability and workers' compensation insurance covering Jerry and others he engaged to assist him. She pays them an hourly rate, and exercises almost constant supervision over the work. Jerry is not free to transfer his assistants to other jobs. He may not work on other jobs while working for Wilma. He assumes no responsibility to complete the work and will incur no contractual liability if he fails to do so. He and his assistants perform personal services for hourly wages. They are employees of Wilma White.

Example 2. Milton Manning, an experienced tile setter, orally agreed with a corporation to perform full-time services at construction sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation supplies all materials, makes frequent inspections of his work, pays him on a piecework basis, and carries workers' compensation insurance on him. He does not have a place of business or hold himself out to perform similar services for others. Either party can end the services at any time. Milton Manning is an employee of the corporation.

Example 3. Wallace Black agreed with the Sawdust Company to supply the construction labor for a group of houses. The company agreed to pay all construction costs. However, he supplies all the tools and equipment. He performs personal service as a carpenter and mechanic for an hourly wage. He also acts as superintendent and foreman, and engages other individuals to assist him. The company has the right to select, approve, or discharge any helper. A company representative makes frequent inspections of the construction site. When a house is finished, Wallace is paid a certain percentage of its costs. He is not responsible for faults, defects of construction, or wasteful operation. At the end of each week, he presents the company with a statement of the amount he has spent, including the payroll. The company gives him a check for that amount from which he pays the assistants, although he is not personally liable for their wages. Wallace Black and his assistants are employees of the Sawdust Company.

Example 4. Bill Plum contracted with Elm Corporation to complete the roofing on a housing complex. A signed contract established a flat amount for the services rendered by Bill Blum. Bill is a licensed roofer and carries workers' compensation and liability insurance under the business name, Plum Roofing. He hires his own roofers who are treated as employees for federal employment tax purposes. If there is a problem with the roofing work, Plum Roofing is responsible for paying for any repairs. Bill Plum, doing business as Plum Roofing, is an independent contractor.

Example 5. Vera Elm, an electrician, submitted a job estimate to a housing complex for electrical work at $16 per hour for 400 hours. She is to receive $1,280 every 2 weeks for the next 10 weeks. This is not considered payment by the hour. Even if she works more or less than 400 hours to complete the work, Vera Elm will receive $6,400. She also performs additional electrical installations under contracts with other companies, which she obtained through advertisements. Vera is an independent contractor.

Trucking Industry

Example. Rose Trucking contracts to deliver material for Forest, Inc. at $140 per ton. Rose trucking is not paid for any articles that are not delivered. At times, Jan Rose, who operates as Rose Trucking, may also lease another truck and engage a driver to complete the contract. All operating expenses, including insurance coverage, are paid by Jan Rose. All equipment is owned or rented by Jan and she is responsible for all maintenance. None of the drivers are provided by Forest Inc. Jan Rose, operating as Rose Trucking, is an independent contractor.

Computer Industry

Example. Steve Smith, a computer programmer, is laid off when Megabyte Inc. downsizes. Megabyte agrees to pay Steve a flat amount to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and Steve is not guaranteed any minimum payment for the hours spent on the program. Megabyte provides Steve with no instructions beyond the specifications for the product itself. Steve and Megabyte have a written contract, which provides that Steve is considered to be an independent contractor, is required to pay federal and state taxes and receives no benefits from Megabyte. Megabyte will file a Form 1099-Misc. Steve does the work on a new high-end computer which costs him $7,000. Steve works at home and is not expected or allowed to attend meetings of the software development group. Steve is an independent contractor.

Automobile Industry

Example 1. Donna Lee is a salesperson employed on a full-time basis by Bob Blue, an auto dealer. She works six days a week and is on duty in Bob's showroom on certain assigned days and times. She appraises trade-ins, but her appraisals are subject to the sales manager's approval. Lists of prospective customers belong to the dealer. She has to develop leads and report results to the sales manager.

Because of her experience, she requires only minimal assistance in closing and financing sales and in other phases of her work. She is paid a commission and is eligible for prizes and bonuses offered by Bob. Bob also pays the cost of health insurance and group-term life insurance for Donna. Donna is an employee of Bob Blue.

Example 2. Sam Sparks performs auto repair services in the repair department of an auto sales company. He works regular hours and is paid on a percentage basis. He has no investment in the repair department. The sales company supplies all facilities, repair parts and supplies; issues instructions on the amounts to be charged, parts to be used, and the time for completion of each job; and checks all estimates and repair orders. Sam is an employee of the sales company.

Example 3. An auto sales agency furnishes space for Helen Smith to perform auto repair services. She provides her own tools, equipment, and supplies. She seeks out business from insurance adjusters and other individuals and does all the body and paint work that comes to the agency. She hires and discharges her own helpers, determines her own and her helpers' working hours, quotes prices for repair work, makes all necessary adjustments, assumes all losses from uncollectible accounts, and receives, as compensation for her services, a large percentage of the gross collections from the auto repair shop. Helen is self-employed and the helpers are her employees.

Attorney

Example. Donna Yuma is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. Donna buys office supplies and pays bar dues and membership dues for three other professional organizations. Donna has a part-time receptionist who also does the bookkeeping. She pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past two years, Donna has had only three clients, corporations with which there have been longstanding relationships. Donna charges the corporations an hourly rate for her services, sending monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, mailing costs, and travel costs for which the corporations have agreed to reimburse. Donna is an independent contractor.

Taxicab Driver

Example. Tom Spruce rents a cab from Taft Cab Co. for $150 per day. He pays the costs of maintaining and operating the cab. Tom Spruce keeps all fares he receives from customers. Although he receives the benefit of Taft's two-way radio communication equipment, dispatcher, and advertising, these items benefit both Taft and Tom Spruce. Tom Spruce is an independent contractor.

Safe Harbor Section 530 provisions - In the Revenue Act of 1978, Congress addressed a controversy that had existed since the late 1960's between taxpayers and the IRS as to whether certain individuals treated as independent contractors should be reclassified as employees. Refer to TSB-A-94(4)I for an Advisory Opinion on Section 530 of the Revenue Act of 1978.

Section 530(a) provides that, in general, if, for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and, in the periods after December 31, 1978, all federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no **reasonable basis** for not treating such individual as an employee.

Section 530(a) also provides that satisfaction of the requirement of a **"reasonable basis"** for not treating an individual as an employee for a period can be met if the taxpayer's treatment of such an individual for such a period was in reasonable reliance of any of the following:

(a) Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(b) A past IRS audit of the taxpayer in which there was no assessment attributed to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to a position held by this individual; (NOTE: a taxpayer may not rely on a prior audit if the current working relationship between the taxpayer and their workers is significantly different from their working relationship at the time of the audit.) or

(c) Long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

The above Section 530 relief only applies to the issue of the employer-employee relationship. It does not apply to payments for services which the employer erroneously treated as excludable from the definition of wages or employment. In addition, even if the taxpayer has met the safe harbor rules, Section 530 relief is not available for years in which the appropriate forms 1099 have not been timely filed.

Section 530 Relief is a federally granted relief of certain employment tax liabilities. As such, this relief can only be granted at the federal level and not directly by New York State. We are in a position, **after federal intervention,** to honor the federal grant of relief and do so similarly for New York State purposes. However, if during the conduct of the field audit we determine that there are factors that perhaps were not provided the IRS in the petition for relief which would otherwise disqualify the Section 530 Relief finding, then we are not obligated to conform to this relief for New York State purposes.

The New York State Tax Law does not provide a specific structure by which employers may make direct application to New York for relief under Section 530. Relief should be sought first at the federal level. Audit staff is not obliged to consider the relevancy of Section 530 applications. However, the auditor should be aware of this federal initiative, should take its provisions into consideration when evaluating the circumstances of each individual case, and be reasonable, fair and practical when determining whether there is a liability in evaluating independent contractor issues.

Instances may occur during the conduct of your field audits in which, due to the State's lack of authority to directly grant Section 530 relief, taxpayers may choose to seek to initiate relief from the Internal Revenue Service. In cases such as this, the auditor may suspend audit activity pending the results of the IRS determination and thereafter render an audit determination. If the auditor chooses this course, the auditor should be cognizant of statutes and procure any required waivers.

IRS Classification Settlement Program (CSP) Offers - The IRS initiated this experimental program in order to resolve Employee vs. Independent Contractor cases. The CSP was initially implemented for a two year trial basis for all cases open as of March 5, 1996 in either Examination or Appeals and for all examinations commenced between March 5, 1996 and March 5, 1998. The CSP has since been extended indefinitely.

The CSP was established by the IRS due to several external criticisms, such as the lack of consistency in the application of the common-law rules. In addition, the IRS felt that the time and expenditure spent on these audits were not worth the outcome because the cases were usually settled on appeal in exchange for prospective treatment. Therefore, the CSP was created in order to: reduce the cost and time of resolving reclassification issues for all parties involved; encourage prospective treatment of reclassified workers as employees; approximate the appeals results; and to promote voluntary reclassification of independent contractors.

The CSP provides only five possible outcomes for any examination where independent contractor status is reviewed:

1. If an IRS examiner determines that a business has NOT misclassified a worker as an independent contractor, no reclassification issue exists and a CSP offer is not necessary and should not be made.

2. If an IRS examiner determines that misclassified workers are employees, but federal forms 1099 were NOT timely filed, the taxpayer is not eligible for a CSP offer.

3. If an IRS examiner determines that a business has misclassified a worker as an independent contractor, and forms 1099 were timely filed, the examiner must then determine whether the business is entitled to relief from retroactive and prospective liability for employment taxes under Section 530 of the Revenue Act of 1978, as described in the previous section of these guidelines. If the IRS examiner determines that the employer has NOT met the requirements of Section 530, a CSP offer will be made.

   The CSP offer provides that the taxpayer begins to prospectively treat the workers correctly, as employees, and agrees to a deficiency assessment equal to 100 percent for only the latest year under examination. Prospective treatment means that the taxpayer agrees to begin treating the worker as an employee effective the first day of the quarter following the agreement date (For example: the CSP agreement is signed by the taxpayer and approved by the IRS on March 15, 1996. The quarter ends March 31, 1996. Therefore, the taxpayer should begin treating the workers as employees on April 1, 1996.).

4. If the business has misclassified the worker, forms 1099 were timely filed, and the business has met the requirements of Section 530, no assessment

should be made, nor should an examiner request any changes in the employer's treatment of the workers for employment tax purposes. However, a CSP offer for prospective treatment will be made to the taxpayer because some taxpayers may prefer to treat workers as employees. This is purely at the option of the taxpayer, and the taxpayer may begin treating the workers as employees currently or at the beginning of the next year.

5. This situation occurs when the business has misclassified the worker, the business has timely filed forms 1099, and the examiner cannot conclusively determine whether or not the business clearly meets the requirements of Section 530. The CSP offer in these circumstances includes prospective compliance and agreement to a deficiency assessment equal to 25 percent of the latest audit year deficiency. As with the 100 percent CSP assessment described in number 3 above, the taxpayer should begin treating the worker as an employee effective the first day of the quarter following the agreement date.

The auditor should be aware of this federal initiative, as a taxpayer under a New York State withholding tax field audit may have accepted a CSP offer from the IRS. As with Section 530 relief, it is also important to note that while New York State does not have authority to enter into a CSP agreement with a taxpayer, the auditor may take such an agreement into consideration when evaluating the circumstances of each individual case. Again, New York State auditors should, as always, be reasonable, fair and practical when determining whether there is a liability during the conduct of cases involving independent contractor issues.

7) OTHER AUDIT ISSUES

Offshoot cases - The withholding tax audit is unique in that it exposes the auditor to a wide range of issues not encountered in other types of audits. Auditors have a wide variety of information available to them on the computer system that may be useful prior to and during the audit, as well as the ability to request audits on C-Corporations, S-Corporations, Partnerships and individual tax returns if there appears to be audit potential.

For example, a review of W-2, NYS-45, NYS-45-ATT or other information reviewed on audit might raise questions regarding possible residency or wage allocation issues for personal income tax audits. In these instances, the auditor should be aware of questionable information on the W-2's, such as New York addresses for individuals filing as non-residents. Or, the auditor might be conducting the audit at the New York place of business in the presence of an officer or shareholder who shows on their W-2 an address that does not make sense, such as Florida. In each of these instances, the auditor should first ask pertinent questions or request the appropriate information in an attempt to resolve the relevant issues for the individual in doubt. Then, only after the auditor is confident that a valid audit issue exists should the auditor consider requesting an audit on these individuals.

Also, in conjunction with a review of 1099's for the reclassification of independent contractors, the auditor should review 1099's for compliance purposes. A test check of the 1099's issued to individuals should be made to insure that both residents and nonresidents are filing personal income tax returns and reporting the 1099 income to New York State. If an individual is not reporting 1099 income earned in New York State on their individual tax return, the auditor should consider requesting an audit.

The auditor should also review the overall tax returns of the Corporation, S-Corporation or Partnership under audit. Issues such as distributions to shareholders of Corporations, AAA account for S-Corporations, guaranteed payments to partners of a Partnership, or business allocation issues for any of these entities could uncover other potential audit issues. In addition, issues that affect other taxes may be discovered, such as sales tax or corporation tax. Therefore, when appropriate, the auditor should either request a case for audit or refer the case to the appropriate Audit Division staff.

Furthermore, in certain withholding tax audit cases, it may be important that the auditor review the expenses taken on the employer's tax return, including "Other Deductions." This may disclose additional compensation paid to employees that may not be included on the W-2's. This may also cause the disallowance of S-Corporation, Partnership or Sole Proprietor expenses that will flow through to the individual shareholder or partner tax returns. Therefore, although the substantiation of expenses may only affect an S-Corporation's, Partnership's or Sole Proprietor's income, which is not a withholding tax issue, the examination of certain expenses is important to the overall purpose of a withholding tax audit.

The new policy of allowing the employer to rely on the New York work percentage shown on the IT-2104.1 and the new policies regarding withholding on income earned in one year and paid in a later year may lead to situations where the auditor will need to create individual audit cases. For a further discussion of these issues, please refer to Section II(B), Part(5), of these guidelines.

Expenses - When examining the employer's Corporation or Partnership tax returns, the auditor should mainly identify those expenses that will affect the employer's withholding tax returns. However, the auditor may also review expenses for substantiation that will either affect the income of an entity, or an individual's personal income tax return. This decision should be based upon materiality and should be relevant to a particular audit issue. If questioned, the auditor should always explain his reason for requesting substantiation. The auditor should also explain that although it is a withholding tax audit, the auditor may examine any issue that appears questionable on the employer's Corporation or Partnership tax return.

The auditor should also evaluate expenses that may be deemed as constructive dividends. A constructive dividend usually occurs where certain business expenses have been claimed on the tax return, but in fact these expenses were for the personal use of an individual, officer, or shareholder of the entity. For example, if an officer or shareholder purchases or leases a car, pays the mortgage on his house, or goes on vacation, and takes the expense on the employer's tax return, these expenses will be considered as personal expenses. This audit change will have a dual effect. The auditor will disallow the expense on the Corporation tax return, and the auditor will also increase the income on the individual's personal income tax.

After the auditor has identified a potential constructive dividend issue from the tax return, the auditor should review that expense account in the general ledger. This may enable the auditor to obtain some detail as to the exact nature of the expense and, as a result, determine if the constructive dividend issue still exists. Then, the auditor should ask relevant questions of the employer or representative, and request and review the receipts for these expenses in order to determine if these expenses were in fact constructive dividends. Here, if the records available for review are voluminous, the auditor may use a sample of a few months in order to achieve an accurate determination. Other records that may be helpful include employee expense accounts and/or travel vouchers.

These same expenses might also display an indication as to a permanent place of abode within New York State. In addition to the above, rent expense, telephone expense or garage expense might signify that a corporate apartment exists for the use of an officer, shareholder or partner. In these instances, the auditor should always question the employer as to who is using the apartment, as well as how often, so the auditor can make an informed decision as to whether or not to pursue a residency audit.

And, finally, certain expenses might also include hidden wages for which there were no withholdings. For example, expenses such as promotion fees, sales commissions or bonuses should warrant further examination.

Fringe Benefits - The employer generally must include fringe benefits in an employee's gross income. These benefits may also be taxable and subject to New York State personal income tax withholding. Fringe benefits may include, but are not limited to, employer provided cars, flights on private aircraft, free or discounted commercial flights, vacations, discounts on property or services, memberships in country clubs or other social clubs, and tickets to entertainment or sporting events. In general, the amount that must be included is the amount by which the fair market value of the benefit is more than the sum of what the employee paid for it plus any amount the law excludes.

Although normally excluded from wages, the below noted fringe benefits are not excluded from highly compensated employees unless the benefit is available to employees on a nondiscriminatory basis.

- No-additional-cost services: services provided to employees at no additional cost to the employer.
- Qualified employee discounts
- Meals provided at an employer operated eating facility
- Reduced tuition for education provided by educational organizations to its employees

Please refer to IRS Publication 15-B for additional information regarding fringe benefits.

Transferee liability - In instances where it is possible that there is a new business, which is in substance the old business with a new name and identification number, the auditor may be able to proceed against this new employer for the prior employer's liability. If the case meets the district office materiality threshold, and there appears to be a connection between the new entity and the employer under examination, it is recommended that the auditor pursue the new entity for the defunct employer's liability. This is allowable per Tax Law Section 693 on transferee liabilities.

There is case law that allows for the assessment of the second or "successor" entity if the second corporation is considered the mere continuation of the old business:

Today's Child Learning Center, Inc. v US, DPa Mar 6, 1998: A newly formed corporation was found liable for the employment tax liabilities of another corporation because it was found to be the successor in interest and alter ego of that corporation. Among other factors, the officers and shareholders were virtually identical and control of the corporations remained in the same hands. The successor corporation was in the same business, providing the same services at the same location. In addition, the original corporation's assets, such as good will, employees, furniture, equipment and premises were used and assumed by the new corporation.

Vincent Costello et al., Petitioners, v New York State Department of Taxation and Finance, Respondent. Supreme Court, Special Term, Ulster County, August 16, 1985: The court found that "as to the withholding and sales taxes, there is no question that as successor to the restaurant business, regardless of the business form, petitioner Costello and his corporation are statutorily liable for the taxes (see, Tax Law Section 693, 1141, respectively)." The petitioner was the son of the sole shareholder and president of the Capri 400 restaurant and a corporate vice-president that purchased the assets of the corporation from his mother and continued to operate the restaurant business under the new corporate name of Capri "400", Inc. In view of his involvement in the affairs of the Capri 400 restaurant and his role as the shareholder distributee of the dissolved corporation, the successor corporation, Capri "400", Inc. was deemed a "transferee" liable for the payment of the franchise taxes of the dissolved corporation.

IV. ***ADDITIONS TO TAX AND CIVIL PENALTIES***

The three most common reasons for tax penalties are: (1) late filing, (2) overdue taxes, and (3) underpayment of estimated tax. Therefore, employers can avoid being assessed penalties and interest by filing their tax returns and paying the correct amount of taxes on time.

Penalties for late filing and delinquent taxes are generally based on the amount of tax that is overdue. However, there are various penalties for late filing whether or not the employer owes any taxes. In addition, whether or not the employer agrees with an assessment, both interest and penalties continue to be added to the amount due until payment is received.

The employer should always be provided the opportunity to explain the delinquency or failure to withhold tax if penalties are to be imposed at the completion of a withholding tax audit on an employer. In addition, the auditor should note his basis for the issuance of any penalties. If the penalties are subsequently waived, the auditor should then either note his basis for waiving the penalties or obtain a reasonable cause letter from the employer or representative.

In general, additions to tax, penalties, or interest imposed pursuant to certain sections of Section 685 of the Tax Law may be waived if a taxpayer, employer or other person against whom the assessment has been made establishes that the failure to comply with the law was due to reasonable cause and was not due to willful neglect. The absence of willful neglect alone is not sufficient grounds for not imposing additions to tax or penalties or for canceling additions to tax or penalties. For a detailed explanation as well as the requirements and grounds for reasonable cause, please refer to Part 6 of this section of the Withholding Tax Field Audit Guidelines.

1) EMPLOYER'S LIABILITY FOR WITHHELD PERSONAL INCOME TAXES

According to Regulation Section 175.1, every employer required to deduct and withhold New York State personal income tax under Section 671 of the Tax Law is liable for the payment of such New York State personal income tax whether or not it is collected from the employee by the employer. Where, for example, the employer deducts less than the correct amount of New York State personal income tax, or where such employer fails to deduct and withhold any part of such New York State personal income tax, such employer is nevertheless liable for the correct amount of withheld New York State personal income tax.

For purposes of assessment and collection, any amount required to be withheld and paid over to the Tax Department, and any additions to tax, penalties and interest with respect thereto, shall be considered the tax of the employer.

- *Withheld wages trust fund* - Any amount of New York State personal income tax deducted and withheld from an employee's wages constitutes a special fund in trust for the Department of Taxation and Finance.

C *No employee right of action* - No employee shall have any right of action against such employee's employer in respect to any moneys deducted and withheld from such employee's wage and paid over to the Department of Taxation and Finance in compliance or in intended compliance with the Tax Law.

2) EMPLOYER'S FAILURE TO WITHHOLD

Regulation Section 176.1 states that if an employer fails to deduct and withhold tax as required, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer, but the employer shall not be relieved from liability for any penalties, interest, or additions to the tax otherwise applicable in respect to such failure to deduct and withhold.

Regulation Section 176.1 further states that the employer will not be relieved from his liability for payment of New York State personal income tax required to be deducted and withheld, unless he can show that the New York State income tax against which the New York State personal income tax, required to be deducted and withheld under section 671 of the Tax Law, may be credited has been paid.

These requirements were also reiterated within TSB-M-91(6)I (see Appendix ~~A~~ B). This Taxpayer Services Division Technical Services Bureau Memorandum was issued in 1991 in order to emphasize specific areas in which the Tax Department discovered some misunderstandings that had existed concerning employers' requirements relating to the withholding of New York State, New York City and Yonkers personal income taxes and nonresident earnings taxes.

The guidance that TSB-M-91(6)I provided to employers was intended to help employers correct certain withholding tax problems identified by the Department's audit staff and thus avoid the imposition of penalties and interest for failure to properly comply with the withholding tax rules. More importantly, this memorandum officially placed employers on notice so there should not be any misunderstandings in the future about the New York State withholding tax law. In addition to the above mentioned general withholding requirements, the following areas of importance were stressed: wages subject to withholding, employee withholding tax certificates, special situations and penalties.

3) DESIGNATION OF AUTHORIZED THIRD PARTIES TO PERFORM ACTS REQUIRED OF EMPLOYERS

As per Regulation Section 177.1, in the event wages or compensation of an employee or group of employees, employed by one or more employers, is paid by a fiduciary, agent or other person or if such fiduciary, agent or other person has the control, receipt, custody or disposal of such wages or compensation, the Tax Commission may authorize such fiduciary, agent or other person to perform such acts as are required of such employer or employers under article 22 of the Tax Law.

a) *Application for authorization to act as agent required* - An application for authorization to act as agent must be filed with the Tax commission and must be accompanied by a notice of appointment of agent executed by each employer for whom the agent is to act.

b) *Liability of fiduciary, agent or other person authorized to act as agent* - Upon approval of the application for authorization to act as agent, all provisions of the Tax Law (including penalties) applicable to employers become applicable to such fiduciary, agent or other person so authorized to act. However, each employer for whom such fiduciary, agent or other person is authorized to act remains subject to all provisions of the Tax Law (including penalties) applicable to an employer.

Reporting or Service Agencies - Regulation Section 174.8 states that employers or groups of employers may utilize a reporting or service agency to file New York State employer's returns and remit payments of withheld taxes on their behalf. The filing of New York State employer's returns and remittance of withheld taxes by a reporting or service agency on behalf of employers or groups of employers does not relieve each such employer from all provisions of law (including penalties) applicable in respect of employers.

4) LIABILITY OF UNAUTHORIZED THIRD PARTIES PAYING OR PROVIDING FOR WAGES

As per Regulation Section 178.1, the following applies to a lender, surety or other person, who is not authorized to perform acts required of employers with respect to an employee or group of employees:

Personal liability in case of direct payment of wages - If a lender, surety or other person, who is not an employer with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety or other person shall be liable for the amount of taxes, together with interest, required to be deducted and withheld from such wages by the employer.

Personal liability where funds are supplied - If a lender, surety or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by Article 22 to be deducted and withheld by such employer from such wages, such lender, surety or other person shall be liable for the amount of the taxes, together with interest, which are not paid over to the tax commission by such employer with respect to such wages. However, the liability of such lender, surety or other person shall be limited to an amount equal to twenty-five percent of the amount so supplied to or for the account of such employer for such purpose.

5) SECTION 685

As per Section 685 of Chapter 60, Article 22 of the New York State Tax Law, the auditor may assess the following penalties on employers where applicable:

685(a) (1) *Failure to file tax return*

(A) In the case of failure to file a tax return on or before the prescribed date, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return five percent of the amount of such tax if the failure is for not more than one month, with an additional five percent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five percent in the aggregate.

(B) In the case of a failure to file a return of tax within sixty days of the date prescribed for filing of such return, unless it is shown that such failure is due to reasonable cause, the addition to tax under subparagraph (A) of this paragraph shall not be less than the lesser of one hundred dollars or one hundred percent of the amount required to be shown as tax on such return.

(C) The amount of tax required to be shown on the return shall be reduced by the amount of any part of the tax which is paid on or before the date prescribed for payment of the tax and by the amount of any credit against the tax which may be claimed upon the return.

(2) *Failure to pay tax shown on return*

In case of failure to pay the amounts shown as tax on any return required to be filed, on or before the prescribed date, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return one-half of one per cent of the amount of such tax if the failure is not for more than one month, with an additional one-half of one per cent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five per cent in the aggregate.

(3) *Failure to pay tax required to be shown on return*

In case of failure to pay any amount in respect of any tax required to be shown on a return required to be filed which is not so shown within ten days of the date of a notice and demand therefore, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount of tax stated in such notice and demand one-half of one per cent of such tax if the failure is not for more than one month, with an additional one-half of one percent for each additional month or fraction thereof during which such failure continues, not exceeding twenty-five per cent in the aggregate. For the purpose of computing the addition for any month, the amount of tax stated in the notice and demand shall be reduced by the amount of any part of the tax which is paid before the beginning of such month.

(4) *Limitations on additions*

(A) With respect to any return, the amount of the addition under paragraph one of this subsection shall be reduced by the amount of the addition under paragraph two of this subsection for any month to which an addition applies under both paragraphs one and two. In any case described in subparagraph (B) of such paragraph one, the amount of the addition under such paragraph one shall not be reduced below the amount provided in such subparagraph.

(B) With respect to any return, the maximum amount of the addition permitted under paragraph three of this subsection shall be reduced by the amount of the addition under paragraph one of this subsection (determined without regard to subparagraph (B) of such paragraph) which is attributable to the tax for which the notice and demand is made and which is not paid within ten days of such notice.

685(b) *Deficiency due to negligence*

(1) If any part of a deficiency is due to negligence or intentional disregard of this article or rules or regulations, (but without intent to defraud), there shall be added to the tax an amount equal to five percent of the deficiency.

(2) There shall be added to the tax (in addition to the amount determined under paragraph one of this subsection) an amount equal to fifty percent of the interest payable under section six hundred eighty-four with respect to the portion of the underpayment described in such paragraph one which is attributable to the negligence or intentional disregard referred to in such paragraph one, for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

685(e) *Deficiency due to fraud*

(1) If any part of a deficiency is due to fraud, there shall be added to the tax an amount equal to fifty percent of the deficiency.

(2) There shall be added to the tax (in addition to the amount determined under paragraph one of this subsection) an amount equal to fifty percent of the interest payable under section six hundred eighty-four with respect to the portion of the underpayment described in such paragraph one which is attributable to fraud, for the period beginning on the last day prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax (or, if earlier, the date of the payment of the tax).

(3) The addition to tax under this subsection shall be in lieu of any other addition to tax imposed by subsection (a) or (b).

Section 685(f) *Non-willful failure to pay withholding tax*

If any employer, without intent to evade or defeat any tax imposed or the payment thereof, shall fail to make a return and pay a tax withheld by him at the time required by or under the provisions of section six hundred seventy-four, such employer shall be liable for such tax and shall pay the same together with interest thereon and the addition to tax provided in section (a), and such interest and addition to tax shall not be charged to or collected from the employee by the employer.

Section 685(g) *Willful failure to collect and pay over tax*

Any person required to collect, truthfully account for, and pay over the tax imposed, who willfully fails to collect such tax or truthfully account for and pay over such tax or willfully attempts in any manner to evade or defeat the tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No addition to tax under subsections (b) or (e) shall be imposed for any offense to which this subsection applies. The tax commission shall have the power, in its discretion, to waive, reduce or compromise any penalty under this subsection.

Willfulness - The term willfulness, according to Internal Revenue Code Section 6672, does not embrace any bad motive or evil intent on the part of the responsible party. Rather, all that must be shown is that the act was voluntary, conscious, and intentional. It need only be shown that the responsible party was aware of the outstanding taxes and knowingly and intentionally used funds to pay operating expenses or other debts of the business. In the matter of Malkin v. Tully, (1978), 65 A.D.2d 228, the court stated that no showing of intent to deprive the Government of its money is necessary, only something more than accidental nonpayment is required.

Responsible Person - Internal Revenue Code section 6672 states that a responsible person may be an officer, an employee, a director, or a shareholder of a corporation, a member or employee of a partnership, or some other person with sufficient control over funds to direct disbursement of such funds.

The key factor in determining a responsible person is control, because even though a corporate employee may have the title of president or director, he may not exercise real authority. Rather, a responsible person is one who has the duty to perform or the power to direct the act of collecting, accounting for, and paying over trust fund taxes. In the matter of Malkin v. Tully, (1978), 65 A.D.2d 228, factors considered important were whether the petitioner signed the tax return, derived a substantial part of his income from the corporation, or had the right to hire and fire employees.

While no one factor is controlling, some indicia of a responsible person are:

- officer, director, stockholder of corporation/business
- authorization to sign tax returns
- responsible for maintaining/managing books
- involved in decision making process of company/corporation
- deriving substantial portion of income from duties
- authority for management of company/corporation
- knowledge and control over financial affairs
- authority to pay other creditors
- authority to hire and fire employees
- authority to sign checks/payroll checks
- authority to negotiate with tax department or accountant on tax issues
- authorization to prepare tax returns
- authority to make purchases for company/corporation
- responsible for other tax remittance
- authority to negotiate loans/borrow money for company
- in a closely held corporation:
  - knowledge of corporate affairs
  - benefits received from profits of corporation
  - duties and function outlined in Certificate of Incorporation or by-laws
  - amount of time devoted to business

It should be noted that the auditor may identify more than one responsible person for the same employer. Therefore, due to the difficulty in evaluating the many factors indicated above, the auditor should exercise careful judgment in deciding which individual or individuals are to be deemed responsible for the withholding and submission of taxes to New York State.

The ultimate consequences of issuing an assessment and holding an individual liable for the actions of the employer under examination can be substantial for the individuals assessed. Each responsible person assessed is accountable for payment of this penalty, which represents 100% of the employer's tax liability. However, once the employer's tax liability is satisfied in full (whether paid by the employer, responsible persons, or any combination), collection ceases on all responsible persons ***(Matter of Phillips and Shein,*** TSB-D-95(15)I). Therefore, the tax assessed against the employer can be collected only once by the Tax Department, and the total penalty assessed for all responsible persons cannot be collected in excess of the total tax assessed the employer.

It should also be noted that there is no statute of limitations for the issuing of responsible person assessments. The Appellate Division has established that the three year statute of limitations in section 683(a) of the Tax Law does not apply in this situation (***Matter of Wolfstich v. New York State Tax Commn***., 106 AD2d 745, 483 NYS2d 779).

Please refer to Section III(3) of these guidelines, *Responsible Persons*, for additional information regarding the identification and assessment of responsible persons.

Section 685(h) *Failure to file certain information returns*

(1) Except as otherwise provided in this paragraph, in case of each failure to file a statement of a payment to another person, required under authority of subsection (d) of section six hundred fifty-eight (relating to information at source) on the date prescribed therefore (determined with regard to any extension of time for filing), unless it can be shown that such failure is due to reasonable cause and not to willful neglect, there shall, upon notice and demand from the Commissioner and in the same manner as tax, be paid by the person so failing to file the statement, a penalty of fifty dollars for each statement not so filed, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed ten thousand dollars.

Section 685(i) *Additional penalty*

Any person who with fraudulent intent shall fail to pay, or to deduct or withhold and pay, any tax, or to make, render, sign or certify any return or to supply any information within the time required by or under this article, shall be liable to penalty of not more than one thousand dollars, in addition to any other amounts required, to be imposed, assessed and collected by the tax commission. The tax commission shall have the power, in its discretion, to waive, reduce or compromise any penalty under this subsection.

The 685(i) penalty is normally assessed by audit staff for a failure to supply requested information within the time required. Therefore, if the requested information is subsequently provided to the auditor, the section 685(i) penalty should be canceled in full. As a result, in addition to the 685(i) penalty assessment, the auditor should always issue an estimated tax assessment for employers that filed tax returns during the years under audit. This procedure will ensure that the statue of limitations does not expire as a result of the cancellation of the 685(i) penalty assessment.

Section 685(j) *Fraudulent statement or failure to furnish statement to employee*

In addition to any criminal penalties provided by law, any person required under the provisions of section six hundred seventy-two to furnish a statement to an employee, who willfully furnishes a false or fraudulent statement, or who willfully fails to furnish a statement in the manner, at the time, and showing the information required under section six hundred seventy-two, or regulations prescribed thereunder, shall for each such failure be subject to a penalty under this article of fifty dollars.

Section 685(m) *Determination of deficiency*

For purposes of subsections (b) and (e), the amount shown as the tax by the taxpayer upon his return shall be taken into account in determining the amount of the deficiency only if such return was filed on or before the last day prescribed for the filing of such return, determined with regard to any extension of time for such filing.

Section 685(n) *Person defined*

For purposes of sections (g), (i), (o), (q), and (r), the term person includes an individual, corporation, partnership or limited liability company or an officer or employee of any corporation (including a dissolved corporation), or a member or employee of any partnership, or a member, manager or employee of a limited liability company, who as such officer, employee, manager or member is under a duty to perform the act in respect of which the violation occurs.

Section 685(v) *Failure to perform certain acts with respect to the quarterly combined withholding and wage reporting return*

There are several penalties noted under this subsection, the majority of which are administered by the Taxpayer Services Revenue Division. Although the auditor should just be aware of these penalties, the auditor should review Tax Department records during pre-audit analysis for these and all other assessments issued by the Taxpayer Services Revenue Division.

Some of the penalties in this subsection are as follows:

- (1)(A) Delinquency
- (1)(B) Late filing
- (3) Failure to provide complete and correct employee withholding reconciliation information
- (4) Failure to provide complete and correct quarterly withholding information not relating to individual employees
- (5) Failure to file using prescribed format

Please refer to the Section 685(v) of the Tax Law for details.

6) REASONABLE CAUSE

Regulation Section 2392.1 states that the additions to tax, penalties, or interest imposed pursuant sections to 685(a), 685(f), 685(h), 685(o), 685(u), 685(v), or 685(w) may be waived if a taxpayer, employer or other person against whom the assessment has been made establishes that the failure to comply with the law was due to reasonable cause and was not due to willful neglect. The absence of willful neglect alone is not sufficient grounds for not imposing additions to tax or penalties or for canceling additions to tax or penalties.

The facts alleged as a basis for reasonable cause may be required to be affirmatively shown in a written statement made by the taxpayer. Where the taxpayer is unable to provide such a statement or does not have a personal knowledge of such facts, a showing of reasonable cause may be made by an individual with a personal knowledge of such facts. In determining whether reasonable cause exists, in addition to an evaluation of such facts, the taxpayer's previous compliance record with respect to all of the taxes imposed pursuant to the Tax Law may be taken into account.

As per Audit Division Memo A-98-1, there is no requirement that the auditor request the waiving of penalty and the grounds for reasonable cause in writing, and penalty should not be imposed automatically where the taxpayer has failed to submit a written request documenting reasonable cause. The auditor should refer to Memo A-98-1 for further guidance.

GROUNDS FOR REASONABLE CAUSE - The following exemplify grounds for reasonable cause, where clearly established by or on behalf of the taxpayer, employer or other person:

(1) The death or serious illness of the taxpayer or the unavoidable absence of the taxpayer from the usual place of business, which precluded timely compliance, may constitute reasonable cause provided that:

(a) in the case of the failure to file any New York State income tax return, the applicable New York State income tax return is filed; or
(b) in the case of the failure to pay, pay over or deposit any tax, such amount is paid or deposited within a justifiable period of time after the death, illness or absence. A justifiable period of time is that period which is substantiated by or on behalf of the taxpayer as a reasonable period of time for filing the return and/or for paying any tax based on the facts and circumstances in each case.

<u>Example</u>: *It was established that illness incapacitated the responsible person of an employer during the time required to file New York State withholding tax returns and pay the tax due. It was further established that no other person had access to sufficient information which would have enabled such person to file and pay the withholding tax due. The New York State withholding tax returns were filed and the tax due was paid within a justifiable period of time after the taxpayer recuperated. This constitutes reasonable cause.*

(2) The destruction of the place of business or business records by a fire or other documented casualty, which precluded timely compliance, may constitute reasonable cause provided that:

(a) in the case of failure to file any return, the applicable return is filed; or
(b) in the case of the failure to pay, pay over or deposit any tax, such amount is paid, paid over or deposited, within a justifiable period of time after the casualty takes place.

<u>Example</u>: *The business, together with the withholding tax records, of a taxpayer was destroyed by a documented casualty immediately prior to the due date for filing New York State withholding tax returns and paying the tax due. Due to*

the disorder created by the casualty and the proximity to the due date, the taxpayer could not have been expected to file and pay the tax due. The records of the taxpayer were reconstructed based on available information received from the taxpayer's employees and various banks. Within a justifiable period of time after the casualty took place the New York State withholding tax returns were filed and the tax due was paid. This constitutes reasonable cause.

(3) Inability to timely assemble information. Except as provided in subdivision (e) of this section, the inability for reasons beyond the taxpayer's control to timely obtain and assemble essential information required for the preparation of a complete return, despite the exercise of reasonable efforts, may constitute reasonable cause provided a return, together with a statement of facts, is timely filed and any tax is timely paid or paid over on that portion of the tax liability which can be ascertained. The relevant facts affecting that portion of the tax liability which cannot be ascertained must be fully disclosed with the timely filed return. When such liability is ascertained, and where applicable collected, an amended return must be immediately filed together with payment of any additional tax due.

(4) A pending petition to the Commissioner of Taxation and Finance for an advisory opinion or a declaratory ruling, a pending conciliation conference proceeding in the Bureau of Conciliation and Mediation Services of the Division of Taxation, a pending petition to the Division of Tax Appeals or a pending action or proceeding for judicial determination may constitute reasonable cause, until the time in which the taxpayer has exhausted its administrative or judicial remedies for one or more taxable periods, the returns for which are due subsequent to the filing of the petition.

<u>Example</u>: *An employer is awaiting a determination, after a hearing, of an administrative law judge of the Division of Tax Appeals regarding whether or not their workers are subject to withholding tax and, therefore, required to file New York State withholding tax returns in a prior taxable period. The employer's petition on the matter to the Division of Tax Appeals was filed prior to the current taxable period. The facts and circumstances for the current taxable period are identical to those of the period covered by the petition. The employer's position is arguable and has merit based on case law. This constitutes reasonable cause.*

(5) Any other ground for delinquency which would appear to a person of ordinary prudence and intelligence as a reasonable cause for delay and which clearly indicates an absence of willful neglect may be determined to be reasonable cause.

INABILITY TO OBTAIN AND ASSEMBLE ESSENTIAL INFORMATION -

Except as provided in number (3) above in *GROUNDS FOR REASONABLE CAUSE*, an inability to timely obtain and assemble essential information (including wage and tax statements or returns of information from an employer or payor) required for the preparation of a complete return shall not be a basis for reasonable cause.

Where an inability to timely obtain and assemble essential information required for the preparation of a complete return exists and where extensions of time for filing the return are available, such extensions of time for filing must be obtained, a return which reflects the known tax liability must be filed on or before the extended due date for filing, and any balance of tax must be paid with the return on that portion of the tax liability which can be ascertained and shown on such return. The relevant facts affecting that portion of the tax liability which cannot be ascertained must be fully disclosed with such timely filed returns. When such liability is ascertained, an amended return must be immediately filed together with any additional tax due.

EXTENSIONS OF TIME TO FILE -

(1) With respect to Sections 685(a)(1) or (a)(2) of the Tax Law, reasonable cause will not exist if the taxpayer or the taxpayer's representative could have reasonably been expected to timely request extensions of time to file the return or extensions of time to pay the tax due, but failed to do so. However, reasonable cause may exist where:

no extensions of time to file the return or no extensions of time to pay the tax due have been requested and it is determined that, given the circumstances, it would have been unreasonable to expect such extensions to be requested;

(ii) a taxpayer has complied with and exhausted all of the provisions with respect to extensions of time for filing the return or extensions of time for paying the tax due but was nevertheless unable to file or to pay on or before the extended due dates; or

(iii) for purposes of the additions to tax under 1085(a)(1) and (2), a taxpayer has attempted to comply, pursuant to subparagraph (e)(3)(i) of this section, with the provisions relating to an extension of time for filing the return.

A showing of reasonable cause with respect to the addition to tax under section 685(a)(2) of the Tax Law will be presumed, with respect to any underpayment of tax, where the taxpayer has:

(i) satisfied the requirements of section 157.2 of this Title, relating to an automatic extension of time for filing a tax return; and

(ii) the excess of the amount of tax shown on the tax return over the amount of tax paid on or before the date prescribed for the filing of the tax return (by virtue of tax withheld, payments of estimated tax and the payment in full of the estimated tax liability pursuant to section 157.2 (a)(4) of this Title) is no greater than 10 percent of the amount of tax shown on the tax return; and

(iii) any balance due shown on the tax return is remitted with such return.

APPENDIX A - FORMS

Withholding Tax Responsible Person Questionnaire (NYS Form **AU-434-S)**: Short Form

Withholding Tax Responsible Person Questionnaire (NYS Form **AU-434-L**): Long Form

Employee Wage Statement (NYS Form **AU-7**)

Withholding Tax Issue Identification Worksheet (Form **AU-440**)

Withholding Tax Field Audit Checklist (Form **AU-409**)

Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding (Federal Form **SS-8**)

Withholding Tax Forms Summary (1992 - present)

APPENDIX B - LAW

Employers' Requirements Concerning Withholding of New York State, New York City and Yonkers Personal Income and Nonresident Earnings Taxes (TSB-M-91-(6)I))

Commonly Cited Sections of the New York State Personal Income Tax Law: Withholding Tax

Important Court Decisions

Technical Services Bureau Memorandums

Technical Services Bureau Advisory Opinions