Taxing Income in the New World of Teleworking

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While no one can know with certainty
when the pandemic will burn itself out,
perhaps states and businesses should be
thinking and talking about how to deal with
this new normal

Roxanne Bland[1]

Executive Summary

Covid-19 has accelerated the growth of teleworking/telecommuting in the U.S. As a result, states are having to confront the challenge of determining how best to tax the incomes of employees who live in one state but work remotely for employers located in another state. In Hawaii a resident is taxed on income from all sources (some of that may be taxed by other tax jurisdictions as well) while the nonresident is taxed on income from Hawaii sources only. To avoid double-taxation, 41 states and the District of Columbia that have a broad based personal income tax allow income taxes paid to another state to be credited against income tax liabilities in their home state. For nonresident filers, calculation of Hawaii sourced income is based on the number of days an employee is physically present in Hawaii.

In response to Covid-19 and the boom in teleworking, a dispute between two states—New Hampshire and Massachusetts—emerged when New Hampshire petitioned the U.S. Supreme Court to rule whether it is constitutional for Massachusetts to continue to impose its income tax on New Hampshire residents who used to commute to work in Massachusetts, but now (because of the pandemic), work entirely from home in New Hampshire for Massachusetts companies. Hawaii, along with three other states—Connecticut, Iowa and New Jersey—submitted a "friend of the court" brief in support of New Hampshire's objection. For Hawaii and other states that levy personal income taxes, the issue is not about the two states in dispute but about the broader issue of remote worker taxation.

This brief, with references to Hawaii throughout, examines the complex and emerging issue of taxing remote work arrangements by state governments in the U.S. and how the current practice of taxing workers based on their "physical presence" at work is considered by many to be outmoded. We consider two approaches for reforming state personal income taxation to make it better fit the new world of telework.

One approach is for stakeholder states to get together and forge an agreement on a formula to apportion income not strictly based on physical presence. A key concern with adopting the apportionment approach is that it will lead to not only increased employee and employer tax compliance costs, it will also create demand for new and expensive systems of revenue administration. These issues are not insurmountable.

A second approach assigns tax liabilities to individuals based on where the person lives rather than on where the income is received. Thus, an individual's income received is fully taxed by his/her home state

1 Contributing Editor, Tax Note State, "Teleworking: A Fixture for the Future?" Tax Note State, Vol. 99, January 11, 2021, p. 166.

only. Taxation of income on the basis of residence eases the compliance burden of taxpayers and can be especially important in border states. We note that the residence principle is already practiced in seventeen U.S. states. As well, through tax treaties, the U.S. and some countries agree to tax each other's citizens on the basis of residence. As in the apportionment approach, the scheme works best when all stakeholder states participate in the arrangement. However, getting all the states to participate would be difficult. Data show that Hawaii will lose substantial income tax revenues (in excess of $100 million in tax year 2018) if the state joined the arrangement. In the near term, Hawaii would be better off fiscally under the status quo.

Introduction

Covid-19 has accelerated the growth of teleworking/telecommuting in the U.S. As a result, states are having to confront the challenge of determining how best to tax the incomes of employees who live in one state but work remotely for employers located in another state. This brief, with references to Hawaii throughout, examines the complex and emerging issue of taxing remote work arrangements by state governments in the U.S. and how the current practice of taxing workers based on their "physical presence" at work is considered by many to be "outmoded."[2] We consider options for reforming state personal income taxation that are better at addressing problems that arise due to the growth of teleworking. The brief also examines how a change from current practice might affect Hawaii.

A long-established practice in US state and local tax policy, which Hawaii follows, is for a state government that levies a personal income tax to broadly tax all sources of income in the state. To effect this, Hawaii has two income tax forms. The first is a form for Hawaii residents (Tax Form N-11). The second is a "nonresident" tax form (Tax Form N-15) that has to be filed by an "individual who is in Hawaii for a temporary or transient purpose, and whose permanent domicile is not Hawaii."[3] The key difference between Forms N-11 and N-15 is that a resident is taxed on income from all sources (some of that may be taxed by other tax jurisdictions as well) while the nonresident is taxed on income from Hawaii sources only. On Form N- 15, calculation of Hawaii sourced income is based on the number of days an employee is physically present in Hawaii.

To avoid double-taxation, 41 states and the District of Columbia that have a broad based personal income tax allow income taxes paid to another state to be credited against income tax liabilities in their home state.[4] As a result, the income taxes one pays to his/her work state as a nonresident are subtracted from any income taxes owed to the home state.[5, 6] This avoids overlapping tax claims.[7] Seventeen states simplify the tax-filing

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2 Ellen S. Brody and Cory M. Paul, "In Defense of the 'Convenience of the Employer' Test", Columbia Journal of Tax Law, Vol. 12, No. 1, October 21, 2020 at https://journals.library.columbia.edu/index.php/taxlaw/announcement/view/350 (visited April 24, 2021).

3 https://files.hawaii.gov/tax/forms/2020/n15ins.pdf (viewed on May 16, 2021). Military service members stationed in Hawaii in compliance with military or naval orders are not considered residents and can elect to pay income taxes to their home states. Moreover, a qualifying nonresident civilian spouse of a service member may source his/her income for services performed in Hawaii to his/her state of residence. In partial compensation for Hawaii public services consumed (i.e.. K-12 public education), the federal government provides "impact aid" to the state government. https://www.hawaiipublicschools.org/ParentsAndStudents/MilitaryFamilies/Pages/About-Impact-Aid.aspx (viewed on May 21, 2021)

4 Timothy P. Noonan and Emma M. Sovino, "Covid-19: The Year of the Great Migration," Tax Notes State, Vol. 99, March 1, 2021, pp. 897-902.

5 Though as a general practice the credit is a "non-refundable" tax credit, i.e. if the credit exceeds the amount of the tax liability, the taxpayer cannot get back more than the amount due. Ann Carrns, "The Tax Headaches of Working Remotely." The New York Times, March 12, 2021 at https://www.nytimes.com/2021/03/12/your-money/taxes/2020-taxes-work-from-home.html (visited April 5, 2021).

6 Residents who commute to another state but whose home is in one of the states with no broad-based income tax do not receive any tax credit for nonresident income taxes paid. Individuals are not subject to income taxes in Alaska, Florida, Nevada, South Dakota, Texas, Tennessee, Washington and Wyoming. New Hampshire taxes resident income and dividends only and does not allow any such tax credit. Commerce Clearing House/CCH (2020). State Tax Handbook. Riverwoods, Ill: Wolters Kluwer.

problem by making reciprocal agreements with other states to not tax nonresident earned income.[8] For example, Ohio has agreements with six geographically nearby states that it will not tax the income earned in Ohio by their residents, nor will the six states tax the income of Ohioans who earn income in their state. [9]

Federal courts have ruled that states may tax the personal income of nonresidents "so long as employees have a substantial link to the taxing state, the taxes are fairly related to services provided by that state, and a tax is apportioned fairly and doesn't discriminate against interstate commerce." [10]

The Trend Towards Teleworking

But, as Bob Dylan's famous song notes, "the times-they-are a changin'".[11] With the increasing use of electronic communication such as email, smart phones (and, too, plain old telephone service), voice over the internet protocol, and video-conferencing, more and more employees can work remotely across state lines. This telecommute may occur for a few days a week or month, or for a prolonged period of time. Teleworking has been around in the U.S. for quite some time.[12] The coronavirus pandemic has only accelerated its pace of expansion.[13]

Consider the data. In March, 2021 21% of employed persons in the U.S. teleworked specifically because of the coronavirus pandemic.[14] The percentage was down sharply from 35 percent in May, 2020, the first month such data were collected by the U.S. Bureau of Labor Statistics (BLS).[15] Even as some companies are summoning, or allowing, some of their workers to return to offices, a recent (February 2021) study by McKinsey Global Institute (The Future of work after COVID-19) concludes that "remote work and virtual meetings are likely to continue, albeit less intensely than at the pandemic's peak."[16] Jose Maria Barrero, Nicholas Bloom and Steven J. Davis estimate that "about 22 percent of all full workdays will be supplied from home after the pandemic ends, compared to just 5 percent before." [17]

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7 For further discussion see remarks by Edward A. Zelinsky relating to "Remote Workforce Doctrine and Policy: Short-Term and Long –Term Considerations". Columbia Journal of Tax Law, Vol 12, No 1. October 21, 2020. (visited April 24, 2021)

8 The 17 states are listed in https://www.thebalance.com/state-with-reciprocal-agreements-3193329. (Viewed on May 25, 2021). The US Congress mandates that DC cannot tax the income of residents from any of the 50 states.

9 Indiana, Kentucky, Michigan, Pennsylvania, West Virginia and Illinois. https://www.thebalance.com/filing-multiple-state-tax-returns-3192925

10 Jimmy Vielkind, "States Square Off Over Taxing Remote Workers' Income," Morningstar, December 23, 2020 at https://www.morningstar.com/news/dow-jones/202012234738/states-square-off-over-taxing-remote-workers-income (visited April 5, 2021)

11 https://www.bobdylan.com/songs/times-they-are-changin/

12 Kate Lister and Tom Harnish, The State of Telework in the U.S., How Individuals, Business, and Government Benefit, Telework Research Network, June 2011 at https://www.shrm.org/ResourcesAndTools/hr-topics/technology/Documents/Telework-Trends-US.pdf (visited May 4, 2021); also https://globalworkplaceanalytics.com/telecommuting-statistics (visited May 4, 2021)

13 https://www.opm.gov/FAQs/QA.aspx?fid=b48bf83b-440c-4f1e-a88c-3cdc9d802ac8&pid=75346675-3b92-4aec-831d-58cf5b0e86d2&result=1 (visited April 4, 2021)

14 https://www.bls.gov/news.release/pdf/empsit.pdf (visited April 4, 2021)

15 https://www.bls.gov/opub/ted/2020/one-quarter-of-the-employed-teleworked-in-august-2020-because-of-covid-19-pandemic.htm (visited April 4, 2021)

16 McKinsey Global Institute, The Future of work after COVID-19, February 2021 at https://www.mckinsey.com/featured-insights/future-of-work (visited April 5, 2021). Amazon recently (March 30, 2021) announced that "Our plan is to return to an office-centric culture as our baseline. We believe it enables us to invent, collaborate, and learn together most effectively." Viewed on May 21 at https://www.aboutamazon.com/news/company-news/amazons-covid-19-blog-updates-on-how-were-responding-to-the-crisis#covid-latest

17 Jose Maria Barrero, Nicholas Bloom and Steven J. Davis, Why Working From Home Will Stick, January 21, 2021 at https://nbloom.people.stanford.edu/sites/g/files/sbiybj4746/f/wfh_will_stick_v5.pdf (visited May 5, 2021). Others might argue that it is too early to say how much the world of work will change in the future. See for example, Billy Hamilton, "The Year of Working Remotely," Tax Notes State, Volume 100, May 3, 2021, pp. 503-508.

Across the country, some cities and states are offering generous incentives to mobile workers with high paying jobs to relocate to their jurisdiction and work remotely.[18] They see the trend toward teleworking as an opportunity to recruit skilled new residents (temporary or permanent) to help grow their economies and expand their tax base. In Hawaii, a local business group calling itself Movers & Shakas (M&S) went so far as to launch a program "to attract purpose-driven remote workers, especially returning kamaaina (i.e., former residents), to come to Hawaii and actively contribute to the community." [19] Participants selected for the program must commit to stay at least 30 consecutive days in the state. Those selected "will be welcomed with a free flight to Hawaii and other perks." They also have to give back to the islands through 15+ hours volunteering with non-profits. Nearly 90,000 applicants vied for 50 openings in the first cohort![20]

What the M&S website does not mention explicitly is that those who work remotely from Hawaii have to pay the state's personal income tax.[21] According to the Department of Taxation, Hawaii (Hawaii Revised Statutes Sec. 235-4(b)) does not provide any threshold as to the duration of the time a nonresident spends in Hawaii or the amount of income earned in Hawaii to be taxed.[22] To play down the disincentive of having to pay Hawaii's state income tax, it is pointed out that states that also levy a personal income tax allow income taxes paid to another state be credited against income tax liabilities in the remote worker's home state.[23, 24] Tax attorney Timothy P. Noonan notes that this provision may still expose the remote worker to potential double taxation because rules vary among states.[25] While uniformity would offer a long term solution, Noonan opines that achieving uniformity would be challenging for states given the diversity of their tax systems. [26] The National Conference of State Legislatures (NCSL) attributes their diversity to "vast differences in state economies, resource endowments, demographics, history and citizens' differing expectations of what government ought to do and how taxes should be levied." [27]

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18 Alyson Krueger, "Want to Move to Our Town? Here's $10,000 and a Free Bike, "New York Times, April 30, 2021 at https://www.nytimes.com/2021/04/30/realestate/bentonville-arkansas-moving-incentive.html (visited May 1, 2021); Jeff Ostrowski, "Working remotely? Some cities, states will pay you to move in," Bankrate, April 12, 2021 at https://www.bankrate.com/mortgages/places-paying-bounties-to-lure-residents/ (visited May 2, 2021).

19 https://www.moversandshakas.org (visited April 4, 2021). Liz Farmer characterizes these remote work hubs as "Zoom Towns." Liz Farmer, "The New Company Town," Lincoln Institute of Land Policy, May 17, 2021 at https://www.lincolninst.edu/publications/articles/2021-05-new-company-town-how-rochester-new-york-is-angling-to-be-remote-work-hub (visited May 21, 2021)

20 https://www.hawaiinewsnow.com/2021/02/13/people-applied-movers-shakas-program-first-selected/ (visited April 4, 2021)

21 It may also expose their employers to taxation in states where they may not otherwise have sufficient "nexus" to be taxed. Jared Walczak, "Working from Home Brings Greater Exposure to State Tax Codes," Tax Foundation, March 25, 2020 at https://taxfoundation.org/working-from-home-remote-work-tax-obligations/ (visited April 5, 2021)

22 Christine Donnelly, "Kokua Line: Teleworking from paradise may sting come tax time," Honolulu Star Advertiser, December 17, 2020 at https://www.staradvertiser.com/2020/12/17/hawaii-news/kokua-line/kokua-line-teleworking-from-paradise-may-sting-come-tax-time/ (visited April 4, 2021)

23 Janis L. Magin, "Work from Hawaii," Pacific Business News, January 8, 2021 at https://www.bizjournals.com/pacific/news/2021/01/08/when-wfh-means-work-from-hawaii.html (visited May 5, 2021).

24 State Tax Handbook, op. cit. The extent to which offsetting credits are applied vary by state. For, example Hawaii does not allow a credit to individuals who took up residence in Hawaii after age 65 and prior to July 1, 1976; they are treated as nonresidents for computing income.

25 Timothy P. Noonan, "Remote Workforce Doctrine and Policy: Looking to the New York Approach," Columbia Journal of Tax Law, Vol. 12, No. 1, October 21, 2020 at https://journals.library.columbia.edu/index.php/taxlaw/announcement/view/350 (visited April 24, 2021). For example, states may limit the tax credit amount that would be applied to the nonresident's income at the home state tax rates. See State Tax Handbook, op. cit.

26 Noonan, op.cit.

27 Reproduced in James Mak, "To Tax or Not to Tax: Making a High-Quality State Revenue/Tax System," UHERO blog, March 6, 2020 at https://uhero.hawaii.edu/to-tax-or-not-to-tax-making-a-high-quality-state-revenue-tax-system/ (viewed on May 26, 2021).

Current Practice of Taxing Workers Who Work Remotely

The challenge of taxing employees who work remotely in one state for employers located in another state did not arise because of the Covid-19 pandemic.[28] The problem has gained more urgency as many more employees than before are working not just from neighboring states, but also from places all over the country, abroad, and even on ocean-going cruise ships.

At present, states use a 'workday' approach to taxing nonresident employees whereby an employee pays tax in the state based on the number of days per year that he/she has worked in the state. The "vast majority" of the states verify where the employee is physically present on his/ her workday.[29] A few states employ an exception to the physical presence rule for nonresident teleworkers. Currently, seven states – Arkansas, Connecticut, Delaware, Nebraska, Massachusetts, New York, and Pennsylvania—employ the "convenience of the employer" test to determine when to tax a nonresident employee's income. (Massachusetts has adopted the convenience rule temporarily during the current pandemic.) Consider, for example, New York State, which has been especially aggressive in taxing its citizens who work in another tax jurisdiction. For an employee who works for a firm in New York as well as performing services in several other states, his/ her income taxable by New York is proportional to the number of days he/she spends working in New York compared to the total number of days he/she worked during the year. Moreover, he/she is required to report days worked outside New York for his/her own (as opposed to the employer's) convenience as days worked in New York. Recently, New York state tax officials re-affirmed the state's stance by declaring nonresident tax filers whose primary office is located in New York must consider days telecommuting as days worked in the state unless the employer has established a bona fide employer office at the telecommuter's location to avoid New York state taxation.[30] This new interpretation of the "convenience" rule expands the standard practice of requiring the employee to be physically present in one state.[31, 32]

New Hampshire vs. Massachusetts

In October, 2020 the issue of which state should be allowed to tax nonresident employee incomes came to a head when New Hampshire asked the U.S. Supreme Court to rule whether it is constitutional for neighboring Massachusetts to impose its 5% income tax on employees of Massachusetts firms living and working from other states.[33] New Hampshire argues that it is unconstitutional for Massachusetts to tax New Hampshire residents "who earn their incomes from activities they undertake solely within New Hampshire" and that the Massachusetts tax rule "disrespects New Hampshire's sovereignty." The Massachusetts Attorney General defended the decision stating that nonresident employees who worked in Massachusetts before the state coronavirus emergency would continue to be taxed in the same proportion as during the immediate pre-pandemic period, regardless whether they continued commuting to the Commonwealth to do their work, or performed the same work remotely from home or another location, or varied their location by the day or

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28 Brody and Paul, op. cit. " Also, Noonan, op. cit.

29 Noonan, op. cit.

30 Jimmy Vielkind, "New York Tax Officials Crack Down on Remote Workers," Wall Street Journal, May 6, 2021. (visited May 7, 2021) For more detail, see Noonan, op. cit..

31 Ariele R. Doolitte (November 2020), "Remote Workers Beware: Potential Double Taxation the Convenience Rule" in Tax Stringer/ New York State Society of CPAs. http://www.nysscpa.org/news/publications/the-tax-stringer/stringer-article-for-authors/remote-workers-beware-potential-double-taxation-under-the-convenience-rule#:~:text=%5B2%5D%20Resident%20credits%20can%2C,Delaware%2C%20Massachusetts%2C%20Nebraska%2C%20New

32 Connecticut Conn. Gen. Stat §12—711(b) (2)/(C). "For purposes of determining the compensation derived from or connected with sources within this state, a nonresident …shall include income from days worked outside this state for such person's convenience if such a state of domicile uses a similar test." Cited by Doolittle (November 2020).

33 In the Supreme Court of the United States, State of New Hampshire, plaintiff, v. Commonwealth of Massachusetts, Defendant, Bill of Complaint, October 19, 2020 at https://www.governor.nh.gov/sites/g/files/ehbemt336/files/documents/nh-v-ma-action.pdf (visited on April 5, 2021).

week." [34]

Fifteen states, including Hawaii, have expressed support for New Hampshire. Four of the fifteen—New Jersey, Connecticut, Hawaii and Iowa-- took a further step and joined New Hampshire by filing an Amicus Curiae (i.e. friend of the court) brief.[35] According to the brief, the states that have adopted the convenience rule impact the fiscal wellbeing of the four amici states because the latter provide a credit to residents for taxes paid to those states.

What makes the New Hampshire-Massachusetts case of special interest is that New Hampshire has no personal income tax. Thus, if New Hampshire prevails, "tens of thousands" of more than 100,000 New Hampshire residents (comprising 15% of the state's workers) who made the daily commute to Massachusetts to work before the pandemic (and pay Massachusetts income tax), will receive a "tax windfall". [36]

It is important to note that the issue is not about using tax policy to compete for residents and jobs.[37] Rather, it is about one state (the "production state") seeing its tax base move across the border to another state ("home state"). To illustrate what is at stake if New Hampshire prevails, consider Connecticut, which is "sandwiched" between the financial and tech industry clusters of New York City and Boston. Connecticut, home to residents who routinely commute to New York or Massachusetts, has the chance to realize a "tax windfall" if more residents stay at home to work. But what is Connecticut's tax windfall is a Massachusetts and New York "tax wipeout".

The Supreme Court has yet to decide whether or not it will hear the case. [38] And it is not our intent in this brief to evaluate the merits of New Hampshire's claim.

Is the Current State Tax System Obsolete?

For the rest of the states, the importance of the New Hampshire-Massachusetts dispute is not about either of those two states. What the dispute has done is generate important discussion about how to reform U.S. state personal income taxation going forward. The world of work has changed, but the rules governing the taxation of individual incomes derived from that work have not. Three critical questions arise. Do the long-established tax principles and practices still apply? Does the shift from physical presence to economic presence call for a new way of thinking about how to tax nonresident workers' income? And, for Hawaii, what are the implications for Hawaii's public finances?

To get the right answer, first we are reminded that the federal courts have maintained that taxes are to be "fairly related to services provided by that state." In economic jargon, this view reflects the benefits received/

34 Sean Philip Cotter, "14 states side with New Hampshire in tax suit against Massachusetts," Boston Herald, December 25, 2020 at https://www.bostonherald.com/2020/12/25/14-states-side-with-new-hampshire-in-tax-suit-against-massachusetts/ (visited April 5, 2021).

35 In the Supreme Court of the United States, State of New Hampshire, Plaintiff, v. Commonwealth of Massachusetts, Defendant. Amicus Curiae Brief for States of New Jersey, Connecticut, Hawaii, and Iowa in Support of the Plaintiff, December 22, 2020 at https://www.supremecourt.gov/DocketPDF/22/22O154/164460/20201222111244937_22O154_Amicus%20Brief.pdf (visited April 5, 2021).

36 State of New Hampshire, Plaintiff v. Commonwealth of Massachusetts, Defendant. On Motion For Leave To File a Bill of Complaint. No 22O154, Original.,

37 Although New Hampshire explains throughout its petition that it is a central concern as the state "has long relied on its sovereign policy choices to create the New Hampshire Advantage, which, in turn, attracts both businesses and workers to the State." Ibid.

38 On May 25, 2021, Acting US. Solicitor General Elizabeth B. Prelogar filed a brief with the Supreme Court arguing that the Court should not take up the New Hampshire complaint since New Hampshire failed to make the case that one state's taxation of employees who reside in another state violates a state's sovereignty. Maria Koklanaris, "SG Tells Justices To Pass On NY v. Mass Remote Tax Case". Law360 Tax Authority State & Local, May 26, 2021.

matching principle which requires those who benefit from services provided by a government program to pay for the cost of providing such services.[39, 40] It is the matching principle that states like Massachusetts employ to justify taxing the personal income earned by nonresidents working in Massachusetts where income is created or produced. The argument is that were it not for the public services provided to the employee whether directly or indirectly, there would be no income created in the first place. Thus, that part of the income that is created in the production state should be taxed by the employer's state. Simultaneously, the remote worker from another state also receives state (and local) public services provided by his/her own state. Thus, both states have legitimate claims to tax the worker's income under the benefits received/ matching principle. How best to accommodate each state's claim?

Two Competing Approaches

Factor Apportionment. University of California-Davis law professor Darien Shanske recently wrote a note in the Columbia Journal of Tax Law in which he raises the question as to why work presence has to be physical.[41] He notes that, in terms of long term policy, taxing workers who are linked to the tax state by physical presence at a workplace is increasingly "problematic", because "...physical presence is an increasingly weak proxy for when a jurisdiction is providing sufficient services to justify the imposition of a tax." He argues that "If we are really moving to a more mobile/remote workforce, then ... states should consider taxing workers whose presence is virtual using some kind of [factor] apportionment approach. This is, after all, how we tax the income of interstate businesses and so it is not clear why we should not do this for workers as well, though perhaps with different kinds of formulas." He cautions that what he proposes is "tentative, and is offered to spur responses...."

A key concern with adopting factor apportionment is that it will lead to not only increased employee and employer tax compliance costs (e.g. time sheet reporting, internal audit), but will also create demand for new and expensive systems of revenue administration. However, professional sports and entertainment industries have so far managed to cope with such compliance and revenue administrative problems under the current hodgepodge state income tax system.

There is nothing so inherently complex about apportionment formulae that cannot be addressed by new compliance and administrative software management that is user friendly. For example, the time sheet information could be recorded by the employee with a routine entry spreadsheet click, and then the employer could apply whatever apportionment formula is being applied in the same manner as it now apportions its own business tax base. The basic process is the same that a multistate employer apportions general business

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39 Neil Bruce, Public Finance and the American Economy, second edition, Boston: Addison Wesley, 2001, p. 213; also Roy Bahl and Richard M. Bird, Fiscal Decentralization and Local Finance in Developing Countries, Edward Elgar Publishing, Northhampton, MA, 2018, p. 169.

40 Bahl and Bird (2018, p. 169) note that "one implication of this approach is that localities should be constrained from 'exporting' tax costs to those who do not benefit from local services." In Hawaii tourists pay far more in taxes to the state and the county governments than the value of public services they consume. But James Mak (Tourism and the Economy, Understanding the Economics of Tourism, Honolulu: University of Hawaii Press, 2004, Chapter 12) argues that there are sound economic reasons besides the matching principle that justifies taxing tourists beyond the benefits they receive from consuming public services in Hawaii. Bahl and Bird also note (p. 170) that to apply a strict benefit approach to the provision of local public services, local/regional governments should not be concerned with "redistributive" policy (i.e. the effects of tax policies on different income groups in the community); that should be left to the national government. Moreover, they surmise that local redistributive policies are not likely to be effective. For political reasons, it is not a message that state lawmakers can easily accept.

41 Darien Shanske, "Remote Workforce Doctrine and Policy: Short-Term and Long-Term Considerations," Columbia Journal of Tax Law, Vol. 12, No. 1, October 21, 2020 at https://journals.library.columbia.edu/index.php/taxlaw/announcement/view/350 (visited April 8, 2021). The question of what constitutes "presence" is not considered here. For more discussion in the remote worker context, see Brody and Paul, op.cit.

tax bases among the states in which they operate. [42]

The final step, and admittedly not an easy one, is the determination of which set of factors should be included in an apportionment formula that not only fits both the directive for a "fair apportionment," but also how to properly divide a dollar of employee income between the employer state and the taxpayers home state. In applying the factor apportionment approach, ideally all taxing states would agree to participate.

Taxation on the Basis of Residence. An alternative approach assigns tax liabilities to individuals based on where the person lives rather than on where the income is received.[43] Thus, an individual's income received is fully taxed by his/her home state only. As we noted earlier, the residence principle is already practiced in seventeen U.S. states. (As well, through tax treaties, the U.S. and some countries agree to tax each other's citizens on the basis of residence.[44]) Joseph J. Cordes explains that taxation of income on the basis of the residence principle eases the compliance burden of taxpayers and can be especially important in border states. He also argues that the use of this approach "means that taxes will be neutral with respect to where taxpayers decide to invest and earn their money…facilitating an economically efficient flow of resources among different taxing jurisdictions."[45]

The residence principle works best when all the states participate. However, universal reciprocity, or uniformity, is unlikely to be achieved among sovereign states, each looking after its own interests, absent external (think, federal) intervention. That's because there will be winners and losers. [46]

Consider Hawaii. In the pre-pandemic tax year 2018, 9,971 resident tax returns (N-11) claimed $51.5 million in non-refundable tax credits for income taxes paid by Hawaii residents[47] to another state or country.[48] Under a residence-based income tax system, that amount would be added to the Hawaii state treasury, a windfall for the State of Hawaii. On the other hand, nonresidents filed a total of 102,143 Hawaii individual income tax returns (N-15) with a total tax liability of $180 million before tax credits; after tax credits, the state collected $156 million.[49] Under a resident-based income tax system, the $156 million will now be lost to the state treasury. Overall (and assuming all else remains unchanged), Hawaii would suffer a tax revenue loss of $104.5 million (=$156 million – $51.5 million). Why would Hawaii voluntarily choose to participate in an arrangement that would inflict a huge loss on its state treasury? The loss will compel state lawmakers to raise additional tax revenues in other ways (e.g. increase the state's general excise tax rate (GET) which will largely be passed onto

42 The CCH State Tax Handbook (2020) provides a state-by-state listing of business income and receipts for purposes of general business tax reporting for corporations and noncorporate business alike. Robert P. Strauss, "Apportionment" in Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle, editors, The Encyclopedia of Taxation and Tax Policy, Washington DC: Urban Institute Press, 2005, pp. 14-16.

43 Joseph J. Cordes, "Residence principle," in Joseph J. Cordes, Robert D. Ebel and Jane G. Gravelle, editors, pp. 332-333. op.cit.

44 https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z (viewed on May 24, 2021)

45 Ibid. Cordes's argument is based on the rationale that, whether a U.S. resident invests abroad or within the U.S., he/she will be taxed at the U.S. tax rate. Actual investment would depend on which investment pays the highest pretax return because that investment will result in the highest after-tax return. The investor will be indifferent between investing in the U.S. or abroad due to tax rate differentials.

46 This can also happen under factor apportionment. Shanske, op.cit

47 According to Hawaii law, "A Hawaii resident is (1) Every individual domiciled in Hawaii, and (2) Every other individual whether domiciled in Hawaii or not, who resides in Hawaii for other than a temporary or transitory purpose. An individual domiciled outside Hawaii is presumed to be a resident if he or she spends more than 200 days in Hawaii during the taxable year. This presumption may be overcome by evidence satisfactory to the Department that the individual maintained a permanent place of abode outside the State and was in the State for a temporary or transitory purpose." At https://files.hawaii.gov/tax/forms/2020/n15ins.pdf (viewed May 16, 2021)

48 State of Hawaii, Department of Taxation, Tax Credits Claimed by Hawaii Taxpayers, Tax Year 2018 (January 1, 2018 – December 31, 2018) at https://tax.hawaii.gov/stats/a5_1annual/a5_4credits/ (viewed on May 22, 2021)

49 State of Hawaii, Department of Taxation, Hawaii Individual Income Tax Statistics, Tax Year 2018 (January 1, 2018 – December 31, 2018) at https://tax.hawaii.gov/stats/a5_1annual/a5_5ind_inc/ (viewed on May 22, 2021).

consumers; raise income tax rates on resident taxpayers; or, the favorite of lawmakers, hike tourist taxes.) In the near-term Hawaii would be better off under the status quo. At some point, however, states may have to consider apportionment or residence options, or perhaps even others that have not yet been suggested. When that happens, Hawaii will once again have to assess how to design a fiscal system that makes the best fiscal sense for the state. [50]

In a world of work that is shifting increasingly toward teleworking, how should Hawaii reform its tax system? We look forward to your comments.

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50 For a discussion of what makes for a good tax system, see Mak, op.cit.