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Gone Fishing: State Nil Reporting and Penalty Notices

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> With warmer weather comes camping trips, family vacations, and…state fishing expeditions? Between state specific nil filing requirements coupled with upscaled reporting portals, taxpayers are increasingly seeing state notices “fishing” for information. In many cases, taxpayers have no reporting obligations, but are being assessed “reasonable penalties” in an attempt by the state to force compliance. In *Gone Fishing: State Nil Reporting and Penalty Notices*, we discuss actions that are triggering these notices and the steps that taxpayers should take to reduce future assessments.

State Nonwage Withholding Requirements – Nil Reporting & Notices

Nuanced state reporting rules have led to awkward results, as taxpayers are forced to navigate increasingly complex state requirements. Once a taxpayer has determined whether information reporting is required for each state, it then must determine how to submit the information. Compounding the issue, taxpayers are required to do this across every reportable jurisdiction and adjust as state agencies retire antiquated systems. Through all this, it is easy to see how taxpayers may get confused during the registration process, though state agencies have not necessarily been sympathetic. Certain state agencies have been issuing notices in an attempt to get taxpayers to divulge information, in some cases assessing exorbitant amounts, deemed by them to be “reasonable penalties.” Understandably, this has caused a bit of a fright for some taxpayers.

Registration

In *Back to Basics: The Combined Federal State Filing Program*,[1] we discussed the requirement by some states to obtain a State ID when submitting Forms 1099. This number connects the information on the Forms 1099 with the payor's state account. However, the form of the State ID varies drastically by state. Although some states permit the payor to use its federal EIN, the bulk of states that require a State ID either require the payor to register through the state portal or with the state tax agency. Though payors may also be prompted to setup a withholding account when registering, this is rarely required for the bulk of nonwage payors. Regardless, some payors inadvertently opt into a withholding account, partly due to confusion with state rules (i.e., they may misunderstand that the registration requirement does not necessitate a withholding account). Conversely, some payors with bifurcated teams find that their payroll departments have inadvertently created a nonwage withholding account – only discovering this when a state notice arrives.

Nil Reporting

Once registered for a withholding account, most states require payors to submit an annual report indicating the amount withheld for the year, and often require the total amount paid and total amount of forms issued (though the requirements vary by state). A handful of states also require nil reporting, though this requirement was rarely or sporadically enforced in the past. For example, instructions to the Connecticut nonpayroll annual reconciliation[2] state: *Payors of nonpayroll amounts registered for Connecticut income tax withholding are required to file Form CT-945* ***even if no tax is due*** (boldened in the actual instructions)*, tax was not required to be withheld, or federal Form 945 is not required to be filed.*

In other cases, state guidance is unclear, though the state has been known to issue notices. For example, the New Jersey instructions[3] blend payroll and nonwage withholding requirements but are unclear whether nonwage nil reporting is required. The instructions state: *Anyone withholding New Jersey Income Tax must file a year-end reconciliation (Form NJ-W-3) … If you stop paying wages during the year, you must file Form NJ-W-3 within 30 days after the last month the business was active or wages were paid.* Guidance on the NJ Taxation webpage provides more direct instructions: *Registered employers must file Form NJ-W-3 even if no wages were paid and no tax was withheld during the year.[4]* The language makes it evident that the state expects an annual reconciliation for payroll withholding, but fails to distinguish whether "employer" is being used strictly in a payroll sense, or in a broader way to encompass nonwage payors that have registered for a withholding account. Despite this ambiguity, the state has issued notices to nonwage payors in the past due to failure to submit nil reports.

Notices & Penalties

The nonwage nil reporting issue is amplified when a payor has no Form 1099 reporting obligations for the year, but fails to submit an annual reconciliation stating that there was no withholding. This oversight is less common in the payroll space because companies typically adjust their withholding status with each state depending on their employee footprint. However, in the nonwage realm, it is pretty standard to have state reporting requirements in some years, but not others. For example, a business may decide to alternate between vendors due to cost or proximity to the work required. Using New Jersey as an example, nil reporting would be required for all years the payor has a registered withholding account. Thanks to New Jersey's

[1] See *Back to Basics: The Combined Federal State Filing Program* at https://tax.kpmg.us/content/dam/tax/en/pdfs/2022/irw-qt-102922-combined-federal-state-filing.pdf.
[2] See Form CT-945, *Connecticut Annual Reconciliation of Withholding for Nonpayroll Amounts*, at https://portal.ct.gov/-/media/DRS/Forms/2022/WTH/CT-945_1222.pdf.
[3] See NJ-WT, *New Jersey Income Tax Withholding Instructions*, at https://www.nj.gov/treasury/taxation/pdf/current/njwt.pdf.
[4] See *NJ Income Tax – Reconciling Tax Withheld With Form NJ-W3* at https://www.state.nj.us/treasury/taxation/njit34.shtml.

electronic filing mandate, payors that submit Forms 1099 directly with the state will also populate and submit the annual reconciliation, thus satisfying their nil reporting requirements in years that they work with New Jersey vendors. However, in years where they alternate to other vendors (i.e., no New Jersey Forms 1099 were required), the payor may neglect to submit an annual reconciliation stating that there was no withholding required. This has triggered soft notices in the past, but we are starting to see more aggressive notices requesting payee information (which likely will not exist, as the payor did not have reporting obligations in the state). Thus, it appears that New Jersey (and other states with similar nil reporting requirements) are using these notices to solicit information (i.e., fishing for missed revenue opportunities).

Far more egregious examples are states that issue notices and assess penalties for phantom income. In a recent case, the state of Connecticut notified a payor that it had missed several years of reporting and withholding, which it calculated to exceed a million dollars. There was no explanation as to how the state arrived at this figure, but the taxpayer was assessed nearly $100,000 based on the state's determination. The taxpayer merely needed to update its information with the state, populating prior year annual reconciliations to indicate that no withholding was required for the years at issue, and the penalty was waived. However, in this case, it was clear that the state was merely fishing for information, combined with hefty motivation to comply.

Tax Portal Upgrades

The Connecticut case is interesting as the taxpayer was not previously on the state's radar, despite its failure to file nil returns in the past. As a standalone case, it appeared to be an anomaly; however, we have seen numerous Connecticut notices recently, making it apparent that something has triggered a change in the agency's collection efforts. Not coincidentally, the nil reports all pertain to tax years after Connecticut transitioned from its antiquated Taxpayer Service Center (TSC) system to its new portal, myconneCT, in 2021. Apparently, the state agency has made good use of the technology rolled out under a multiyear initiative to efficiently identify and escalate missing data. It appears the new myconneCT portal is better able to connect registered payors with reporting deficiencies. Connecticut was not alone, as several states have implemented new portals in the past few years to leverage technology for compliance enforcement. Thanks to improved analytics and efficient data matching systems, taxpayers can only expect portal upgrades to result in more notices as state agencies expand their collection efforts.

Preventive Steps

Clearly, states would prefer taxpayers to meet the nuanced registration, withholding, and reporting requirements. While this can be tricky, there are steps that nonwage payors can take to mitigate reporting burdens and ensure that they minimize the number of notices they receive. For starters, payors should have a good sense of their vendor state footprint, and ensure that they are reviewing state reporting and withholding rules regularly. Once it has been determined that the payor has reporting requirements in a particular state, and confirmed that it does not have withholding requirements, the payor should review the State ID requirements and only register with the state as required. Thus, nonwage payors should avoid registering for withholding accounts unless necessary and may seek to avoid state registration altogether in states with minimal contact. As an example, Pennsylvania is also a nil reporting state, requiring registered payors to submit annual reconcilations. However, Pennsylvania provides the option for nonwage payors with no withholding obligations to submit Forms 1099 without registering with the state. Payors must include additional information when submitting via myPATH, but the extra effort in the short term can often save payors the headache of filing annual nil reports.

The payor should document the reason for the type of registration (e.g., portal access registration only or formal registration with the state tax agency, a withholding account or non-withholding account, etc.). The payor should also document state guidance indicating why the particular type of registration and/or account was necessary. Documentation should be kept in a known and accessible location (e.g., not on one employee's hard drive) with review and maintenance responsibilities delineated by title (to ensure duties are not forgotten with employee turnover). All documentation should be reviewed regularly to ensure compliance is up to date. Key to these steps, departments within an entity must communicate to determine exactly what is required by the entity as a whole. As previously mentioned, it is not uncommon to see a payroll department mistakenly register for a nonwage withholding account, subjecting confused professionals to penalty notices. The preventive frontend efforts will help ensure that businesses can avoid potential penalties and confusion in the long run, particularly as states ramp up fishing efforts to identify missed revenue opportunities.

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