Payroll Insights

Employment tax news to guide you now and for the future

August 2026

John's *fresh take*: The approaching deadline for disallowed ERC claims

Subscribers may recall our January 2024 *Payroll Insights* article entitled "The Employee Retention Credit [ERC] continues to stymie the IRS", the March 2024 article entitled "The ERC sage continues …", or the October 2025 article entitled "The ERC waiting game – what employers need to know." In fact, many editions of *Payroll Insights* released since Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act in March 2020 included updates on the ERC. By the time the statute of limitations for claiming the credit expired (April 15, 2024, for Q1 – Q4 2020, April 15, 2025, for Q1 – Q2 2021, and January 31, 2024, for Q3 – Q4 2021), approximately 5 million claims worth about $250 billion had been submitted. As of July 4, 2026, the IRS reports that there are approximately 20,000 outstanding claims in various stages of processing.

Throughout this journey, the IRS has determined a significant number of disallowances in processing claims. When the IRS completely disallowed a claim, it technically should have issued Letter 105-C to the taxpayer notifying them of the disallowance and taxpayer's right to file suit within two years of the date of the notice. When the IRS partially disallowed a claim, taxpayers should have technically been issued Letter 106-C notifying the taxpayer that the claim has been disallowed in part and the taxpayer's right to file suit within two years of the date of the notice. Once two years have passed from the date of disallowance, the IRS cannot issue a refund even if the IRS later agrees that it should not have disallowed the claim.

For many taxpayers with disallowed claims, the two-year deadline is approaching. Responding to a notice or having an open case in appeals (even if a favorable decision has already been made but a refund has not been processed) **does not** extend the two-year deadline. For a taxpayer to protect their interests, the taxpayer and IRS may jointly agree to extend the statute of limitations in certain circumstances, typically using Form 907, *Agreement to Extend the Time to Bring Suit*, or the taxpayer must initiate the court proceedings to bring suit. It is important to note that an extension of time is not valid until both the taxpayer and the IRS agree to the extension.

There are two key takeaways from the current status of ERC claims:

1. The IRS asserts more than 99.99% of ERC claim reviews and determinations have been completed. If taxpayers have not received a determination from the IRS on a claim, it is imperative for them to call the IRS and confirm if the claim is one of the 0.001% in process. If the IRS asserts that a determination was made, the taxpayer should request a copy of the letter and determine their next steps.
2. If taxpayers received a notice of full or partial disallowance and believe additional amounts are owed, they should determine if it is advisable to request an extension of the right to bring suit or move forward with bringing suit to dispute the IRS's disallowance.

As the window of opportunity to safeguard claims rapidly closes, employers must proactively evaluate their standing with the IRS and identify any necessary protective measures. Working closely with qualified tax professionals can help ensure taxpayers don't inadvertently let crucial filing deadlines slip away, leaving potential refunds permanently on the table.

Federal updates

Automatic penalty relief process

On July 8, 2026, the IRS announced its plans to implement a new process, called the Automatic Exemption from Penalty (AEP), to replace the First Time Abate (FTA) penalty relief.

Under the FTA, employers with a history of compliance for the last 3 years (or 12 quarters for quarterly returns) may be eligible for abatement of certain penalties related to failure to file, pay, or deposit, which are the common assessments against payroll taxes and returns. In some, but not all instances, the IRS automatically applies the FTA. In other cases, the IRS issues penalty notices and the taxpayer must make a formal request to apply the FTA and abate the penalties assessed.

To simplify the process and reduce the burden on taxpayers, the IRS plans to apply the FTA concept automatically with the AEP. The phase-in of the AEP is supposed to start this summer, with full implementation for returns due on or after January 1, 2027. Taxpayers should continue to be vigilant with notices and the potential for penalty abatement. Even if the taxpayer is aware of a late deposit or filing, they should confirm if they are eligible for the FTA (for returns prior to January 1, 2027) or confirm the AEP is applied.

IRS increases 2026 standard mileage rate

The IRS announced that the optional standard mileage rate for business use of a vehicle increased from 72.5 cents per mile to 76 cents per mile due to recent increases in fuel prices. The standard mileage rate is the rate at which a company can take a business deduction and reimbursements can be excludable from employee taxable wages for substantiated business mileage. This is the second rate increase in 2026, following the 2.5 cent adjustment announced in December 2025 due to rising inflation costs.

Announcement 2026-11 revises the optional standard mileage rates beginning July 1, 2026. Business-related travel occurring during the first half of 2026 should continue to be measured/reimbursed using the prior 2026 rate of 72.5 cents per mile, while business miles occurring on or after July 1 should be measured/reimbursed using the revised rate of 76 cents per mile.

Employers that reimburse employees for business-related travel will need to account for this midyear increase within their payroll systems. Employers should also consider whether existing reimbursement system logic can distinguish between mileage incurred before and after July 1, 2026, particularly where employees submit expense reports after the effective date for travel that occurred before the rate change.

IRS finalizes 2026 instructions for Forms 1099-MISC and 1099-NEC

The IRS issued the final instructions for 2026 Forms 1099-MISC, *Miscellaneous*, and 1099-NEC, *Nonemployee Compensation*, on July 1, 2026, with no significant differences from the draft instructions released in April. As a reminder, the 2026 instructions include new reporting fields for cash tips and overtime compensation, as well as new Treasury Tipped Occupation Codes to identify the type of tipped worker. Also, excess golden parachute payments should be reported on Form 1099-NEC, instead of Form 1099-MISC. For tax years beginning after 2025, the minimum reporting threshold for certain payments required to be reported on information returns and/or for performing backup withholding increased to $2,000 from $600. This threshold may be adjusted for inflation beginning in calendar year 2027.

Proposed regulations on excise tax on excessive compensation

In June 2026, the IRS released Notice 2026-36, announcing its intent to issue proposed regulations to clarify the IRS interpretation of the One Big Beautiful Bill Act's (OBBBA) changes to the excise tax on excessive compensation and parachute payments paid to executives by an applicable tax-exempt organization (ATEO) or a related person or governmental entity.

Internal Revenue Code (IRC) Section 4960 provides for an excise tax on certain compensation paid to "covered employees" of an ATEO. The Tax Cuts and Jobs Act of 2017 defined covered employees as an ATEO's top five most highly compensated employees for the taxable year, and anyone who was a covered employee in a prior taxable year beginning after December 31, 2016, with some exceptions. The OBBBA significantly expanded the definition of a covered employee to mean any employee of an ATEO and any former employee of an ATEO who was such an employee during any taxable year beginning after December 31, 2016. The OBBBA amended the statute to provide that the new definition of covered employee applied to taxable years beginning after December 31, 2025.

The Treasury Department and the IRS interpret the effective date provision to broaden the definition of covered employee only for taxable years after December 31, 2025, and retain the prior definition of covered employee with respect to the period prior to the enactment of the OBBBA definitions (i.e., 2017 – 2025). For these years, the IRS would only consider individuals to be covered employees if they qualified as such under prior law. The Treasury Department and the IRS intend to issue proposed regulations providing that prospectively, an individual is a covered employee if (i) they were a covered employee in any taxable year beginning after December 31, 2016, and on or before December 31, 2025 under prior law, and (ii) an individual is an employee of an ATEO in any taxable year beginning after December 31, 2025. The notice also indicates that tax-exempt organizations could continue to rely on the "limited hours" and "nonexempt funds" exceptions for volunteers until further guidance is issued. The IRS is considering comments submitted by the public in drafting the proposed regulations.

Updated foreign per diem rates take effect August 1, 2026

The US Department of State updated foreign per diem rates, effective August 1, 2026. The updates affect cities and regions across multiple countries, including Brazil, Canada, India, and Poland.

State updates

Arizona updates internal revenue code conformity

On June 13, 2026, Arizona updated its tax laws by signing House Bill 4168 into law, which aligns the state's tax code with the Internal Revenue Code as of January 1, 2026. This conformity notably incorporates the federal provisions of the OBBBA enacted back on July 4, 2025. Under the new law, taxpayers can take advantage of retroactive deductions for qualified tips and overtime compensation starting from January 1, 2025. However, the bill also eliminates several tax credits effective January 1, 2026, specifically repealing the insurance premium, individual, and corporate Credits for New Employment.

Connecticut extends no income tax withholding on lump sum distributions

Connecticut extended its tax withholding exemption on certain lump-sum distributions for an additional year, pushing the expiration date from December 31, 2026, to December 31, 2027, under House Bill 5563. Under this extension, if a Connecticut resident receives a lump-sum distribution, no state tax should be withheld unless the recipient explicitly requests it. This rule applies to distributions that exceed either $5,000 or half of the total account balance, whichever of those two amounts is smaller.

New York extends expanded wage deduction rules to 2028

On June 26, 2026, New York Governor Kathy Hochul signed into law Assembly Bill 10342, which extends the sunset date of the state's expanded wage deduction law from November 6, 2026, to November 6, 2028. The original 2012 law restricts the deductions an employer may make from wages to deductions required by governmental agencies, such as wage garnishments and pre-tax contributions to approved benefit plans, benefits authorized by the employee under the New York Labor Law, recovery of certain overpayments, and repayment of certain wage advances. The 2012 law provides categories and examples of deductions specifically listed in the Labor Law (Section 193(1)(b)) and similar payments that may be deducted from wages. It specifically permits voluntary deductions across six main categories, which cover health, pension, charitable, representational, transportation, and food or lodging benefits. Conversely, it prohibits deductions for items like loan repayments, work tool purchases, or employer losses such as spoilage.

For employers, the extension provides continued authority for certain voluntary employee-authorized deductions and certain employer recovery deductions from wages. Employers should confirm that their deduction programs are consistent with New York's specific requirements, including authorization, notice, and any applicable regulatory procedures. Organizations operating nationally should also verify that New York-specific practices remain appropriately reflected in multistate payroll administration procedures.

New York "convenience of the employer" tax rule upheld in two key cases

New York's "convenience of the employer rule" requires employers to source wages paid to employees who are not residents of New York to New York for income tax withholding purposes if the employee is assigned to or primarily reports to a New York business location, even if services are physically performed outside of New York, if the work outside New York is for the convenience of the employer, as opposed to occurring outside of New York out of necessity. New York utilizes a complex set of primary and secondary factors established through various rulings and administrative guidance to determine if an employee's residence outside of New York can be considered a bona fide employer office and, therefore, there is a necessity to perform services from the home office.

Connecticut and New Jersey (in limited circumstances), Delaware, Nebraska, and Pennsylvania impose similar rules on telecommuters. Most other states require wages to be sourced based on physical presence. Therefore, these telecommuting rules are frequently litigated since affected employees may face higher tax rates or find themselves being taxed by both New York and their home state.

Zelinsky v. Commissioner of Taxation and Finance

In a decision issued on July 2, 2026, a New York appellate court rejected a challenge to the Tax Appeal Tribunal's ruling about the state's "convenience of the employer" tax rule. The case, *Zelinsky v. Commissioner of Taxation and Finance*, involved a Connecticut resident who was denied New York personal income tax refunds for work performed remotely during the COVID-19 pandemic.

The appellate court upheld the Tribunal's ruling that the employee's wages for services performed outside of New York should be subject to New York income tax withholding. The Tribunal concluded that the employee performed services from Connecticut for his own convenience and not for the convenience of his employer, even though the employee could not perform services from the employer's office due to COVID-19 pandemic restrictions. The Tribunal noted that employer's indifference to the state from which the employee performed services was an indication that there was not a necessity to perform services outside New York, thereby rendering the New York convenience of employer tax rule applicable.

The Tribunal also concluded that the convenience of the employer rule is constitutional, and that merely performing services from a different state does not trigger the interstate commerce provisions of the federal Commerce Clause that permits the federal government, not state government, to regulate cross-border activities. Nor does it trigger the federal Due Process Clause, which requires only a minimal connection with the state and that the income be "rationally related to values connected with the state."

In the Matter of the Petition of Pamela Snyder

A New York administrative law judge ruled that a nonresident taxpayer was not entitled to a full personal income tax refund from New York state or New York City for work performed from her Florida home during the COVID-19 pandemic because it was not necessary for her to work from Florida under the convenience of the employer rule. The taxpayer argued that the employer's New York offices were closed, and the employees were required to perform services away from the office. As such, she performed services from home out of a business necessity.

The judge found that the employee did not prove that her remote work was a necessity for their employer. Key factors in the decision were that the employee remained assigned to a New York-based role and could perform her duties from any location; the employer did not require the employee to work outside of New York or in a specific jurisdiction. The judge noted that the employee's Florida home did not constitute a "bona fide employer office" and that working from there was not a condition of their employment.

Together, these recent rulings in both Zelinsky and Snyder underscore the high bar New York sets for proving remote work necessity, even during unprecedented office closures. For multi-state employers and remote workers, this administrative stance serves as a reminder that New York continues to strictly enforce its convenience of the employer rule and will continue to source wages paid for services performed outside New York in connection with a New York office unless a clear business necessity is established.

North Carolina updates internal revenue code conformity

On July 2, 2026, North Carolina Governor Josh Stein signed into law Senate Bill 595, which updates the IRC conformity date of North Carolina statute to January 1, 2026. This change adopts the provisions of OBBBA and is effective July 2, 2026.

Ohio updates withholding methods

Effective August 1, 2026, the Ohio income tax withholding rates decreased, as reflected in both the new percentage and computer method tables. The new maximum rate is 3.4%, down from 3.64%.

Oklahoma updates withholding rules for retirement and deferred income

The Oklahoma Tax Commission amended its withholding rules for pensions, annuities, and other deferred income, creating distinct processes for periodic and nonperiodic payments.

- Periodic Payments: No change - withholding is handled similarly to wages, with recipients using Form OK-W-4-P, *Withholding Certificate for Periodic Pension or Annuity Payments*, to declare their marital status and allowances, request additional income tax withholding, or opt out of withholding.
- Nonperiodic Payments: Recipients now have new options using the 2026 Form OK-W-4-R, *Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions*. The individual can elect to have tax withheld at the top marginal rate, add an additional amount to that withholding, or opt out of withholding entirely.

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