The Basics of Moving Expense Taxation

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Scott acquaints readers with the fundamentals of the tax law applying to today's moving expenses with information on gross-up formulas, tax deductions, the definition of reasonable moving expenses and non-reimbursable moving expenses, and the time and distance requirements of the move. Also he provides the most recent information on the tax treatment of home purchase programs, focusing on assigned sale, amended value, and buyer value option (BVO) programs. professionals.

By Peter K. Scott

When an employee is transferred and the employer reimburses his or her moving expenses, it is important not to overlook the resulting tax ramifications. These ramifications have evolved over the years.

The most recent change to the tax code on moving expenses occurred with the passage of the 1993 Omnibus Budget Reconciliation Act.

Reimbursements as Compensation

With the exception of the shipment of household goods and travel to the new location, any relocation expenses that an employer reimburses or pays on behalf of an employee must be included in the employee's gross income. That payment or reimbursement is subject to withholding and employment taxes.

When an employer reimburses its transferees for homesale expenses, temporary living, and househunting, for example, these reimbursements must be reported in the employees' incomes.

Likewise, the provision of miscellaneous and cost-of-living allowances, coverage for loss on homesale, and employer payments for destination home purchase closing costs must be treated as compensation and reported in transferees' W-2 forms.

There is no corresponding moving expense tax deduction and, as a result, the employee faces taxes on these reimbursed expenses.

Most employers make an additional payment, commonly referred to as a "gross-up," to assist employees with this added tax liability.

This gross-up payment also must be reported as income and produces an additional tax liability for the employee. Some employers use a formula that accounts for the taxes not only on the moving expenses, but also on the tax payment. The calculation identifies the amount that should be given to the employee if the employer wishes to cover the taxes on the tax payment, as well as those on the moving expenses.

Options for household goods and travel expenses. Unlike other moving expenses, there are two options for the tax treatment of employer reimbursements for household goods shipment and travel to the new location.

For qualified moves, the employer may include such reimbursements in the transferee's income (and the transferee then may take a tax deduction for them), or exclude these reimbursements from income, which eliminates the need for the employee to take a tax deduction for them.

It should be noted that the elimination of the tax deduction in this second option does not penalize the employee. Since the expenses are not included in income, the employee does not face paying taxes on them.

Income exclusion option. To exclude employer payment for household goods shipment and travel to the new location, certain conditions must be met:

- the expenses must be considered reasonable;
- the transferee must account for his or her actual expenses within a reasonable period of time;
- the transferee must return to the employer any excess of advances over actual expenses within a reasonable time;
- the transferee must not have taken a tax deduction for the expenses on a prior year's tax return; and
- the move must meet the provisions of Section 217 of the Tax Code (outlined later in this article).

Income inclusion option. If an employer elects to forego the income-exclusion provision and includes reimbursed shipment and travel expenses in the transferee's income, then the employee would be allowed a tax deduction for such reasonable expenses, provided the move met the requirements of Section 217 of the Tax Code.

This is an "above-the-line" deduction, meaning that it is deducted in computing adjusted gross income. It is, therefore, available whether or not the individual itemizes his or her deductions.

Consequently, even if the employer elects to include in income reimbursements for the household goods shipment and travel, the offsetting deduction eliminates any tax liability for the employee and makes a tax gross-up for these expenses unnecessary. The employer also would not be required to withhold or pay payroll taxes on the reimbursements, because they are deductible as moving expenses.

Regardless of which option an employer chooses (inclusion in income with offsetting deduction or income-exclusion provision), a tax liability on employer reimbursements for household goods shipment and travel can be avoided on qualified moves.

Reasonable expenses for household goods shipment and travel. The Internal Revenue Service (IRS) defines "reasonable" household goods shipment expenses as the packing, crating, and shipping of household goods and personal effects of the employee and his or her household; disconnecting and connecting utilities; and insurance and in-transit storage for 30 consecutive days. The costs for moving automobiles and pets also are allowed in this expense category.

In the travel category, deductible expenses include transportation and lodging costs for employees and their households on the final trip to the new location. Meals are not part of this category and must be treated as other moving expenses. That is, they must be included as income with no tax deduction.

To qualify for the exclusion or tax deduction provisions outlined above, the employee's move must satisfy the requirements of Section 217 of the Tax Code, which involve work-related, distance, and time tests.

Work-related test. The first requirement of Section 217 is that the move must be closely related in time to the start of work at the new job location. Expenses incurred within the first year after the employee reports to the new location are presumed to meet this test, but expenses incurred later also may be considered to qualify if the delay was due to extenuating circumstances. For example, if the move of the family has been delayed for two years so a child could finish school, those expenses would be deductible.

The 50-mile rule. The distance between the former residence and new place of employment must be at least 50 miles more than the distance between the former residence and former workplace. In other words, if the employee did not change residences, the one-way commute to the new job would have been at least 50 miles more than the commute to the old job.

Consider, for example, an employee living in Annapolis, Maryland, and commuting 10 miles to a job in Baltimore, Maryland. The employee is transferred to a job in Washington, DC, that is 40 miles from the employee's residence.

In this scenario, if the employee moves to be closer to the new job in Washington, DC, the employee will not qualify for the income-exclusion or deduction provisions because the 50-mile rule of Section 217 will not have been satisfied. The distance between the former residence and new job is only 30 miles greater than the distance between the former residence and former job.

The 39-week test. The employee also must meet a 39-week test. The transferee must be a full-time employee in the general area of the new job for at least 39 weeks in the 12-month period following the move in order to meet the Section 217 requirements. Employment does not have to be for 39 consecutive weeks, nor does one have to work for the same employer during this 39-week period (Self-employed individuals have a different time requirement.).

The 39-week test is waived, however, if the employee is transferred again for the benefit of the employer, because of death or disability, or when there is involuntary separation from work. The 39-week rule is not waived if the employee initiates the transfer by applying for a new job through a job posting procedure, or if the second move is expected.

In general then, moves must meet the work-related, time, and distance tests of Section 217 of the Tax Code for employers to exclude from income the expenses of household goods shipment and travel.

If the tests are not satisfied, the reimbursed amounts must be treated as compensation. In such situations, because the move did not meet the Section 217 requirements, the employee would be denied a tax deduction for these expenses.

Thus, failure to satisfy these requirements means the employee faces taxes on shipment and travel reimbursements, just as they would on other moving expenses. The employer then must decide whether or not to assist with this added tax liability by computing and paying a tax gross-up.

Unreimbursed moving expenses. What about individuals whose moves meet the Section 217 requirements but who are not reimbursed by their employers for moving expenses? These individuals are allowed "above-the-line" deductions for the reasonable expenses of household goods shipment and travel to the new location. Because there is no employer reimbursement, there is no issue regarding income inclusion. This tax deduction provides some relief for individuals who are not reimbursed by their employer and must pay their own moving expenses.

Overview. Except for household goods shipments and travel to the new location, employer reimbursements for moving expenses must be included in the transferee's income, and there is no offsetting moving expense deduction for these reimbursements. Consequently, the employee generally faces taxes on the reimbursed amounts, for which the employer may offer assistance through a tax gross-up.

On the other hand, reimbursements for household goods shipments and travel expenses need not be included in the employee's income, provided that certain provisions are met, which include the work-related, time, and distance tests of Section 217. Excluding these reimbursements from income would not generate any tax liability for the employee.

If the employer does include such reimbursements in income, an offsetting tax deduction is available, provided that the work-related, length of time, and distance tests are met. This would likewise eliminate the employee's tax liability on these reimbursements.

Homesale Tax Treatment

Certain home disposal programs (referred to here as home purchase programs) enjoy tax advantages that direct reimbursement of the employee's expenses do not.

Direct reimbursement plans involve payments to an employee that will constitute compensation not offset by a deduction. Properly structured home purchase programs, however, may allow an employee to avoid incurring these costs in the first place (and thus not require the employer to reimburse or provide in-kind services, which would create income to the employee).

The best home disposal program for minimizing the tax liability for both the employer and the employee is one that is structured so that the disposal of the residence is accomplished through two separate, independent sales, rather than one. That is, a home purchase program in which the employer buys the home from the employee. Thus, the most important planning consideration for a home disposal program is how to create two sales: one from the employee to the employer or relocation management company (RMC), and a second sale of the residence by the employer or RMC to a third-party.

Since publication of Rev. Rul. 72-339 in 1972, IRS has agreed that if the employer buys a home from an employee in a bona fide purchase for fair market value, the costs the employer incurs to dispose of the home are not income to the employee. In November 2005, IRS reiterated and expanded on that agreement in Rev. Rul. 2005-74. The 2005 ruling includes considerable detail as to the procedures that will result in a purchase from the employee being considered a bona fide transaction in which the employer obtains all the benefits and burdens of ownership.

The IRS position is based on the premise that two separate, independent sales have occurred, one from the employee to the employer, and a second sale from the employer to the outside buyer. The employee is not a part of the second sale, and does not benefit from it.

Consequently, the costs incurred are considered expenses of the employer incurred for its own benefit to dispose of the home, and not taxable to the employee. Note that this result is unrelated to whether the employee would be allowed to deduct moving expenses. That is, there are no work-related, time, or distance tests.

There are two common exceptions to the principles of Rev. Ruls. 72-339 and 2005-74. First, if costs actually are incurred on the sale between the employee and the employer that local law or custom would impose on the seller (e.g., title insurance or transfer taxes) and the buyer (employer) pays them, that payment counts as taxable wages to the employee and is subject to withholding and payroll taxes. The reason is that the employer paid a cost for which the employee was liable.

Second, if the employer pays more than fair market value for the employee's home, the excess is a "directed offer" and taxed to the employee as wage income, not as homesale proceeds. This amount, too, would be subject to withholding and payroll taxes.

Although Rev. Rul. 72-339 involved a direct purchase by the employer, IRS has repeatedly held in private letter rulings that the result is the same if the purchase and sale is made by a RMC on behalf of the employer. That result is formally confirmed by Rev. Rul. 2005-74.

Consequently, if the program is properly structured as two, independent, bona fide sales, the expenses are not taxable to the employee whether the employer operates the program "in-house" or outsources it to a RMC (with the two exceptions noted above).

Assigned Sale, Amended Value, and BVO

Rev. Rul. 72-339 involved an appraised value purchase program in which the employee did not market the home independently prior to its sale to the employer. Rather, the employer offered the employee the average of two or three appraisals of the home, and purchased it for that price without any necessity for the employee to seek an outside buyer.

Because such programs typically result in substantial carrying costs while the employer attempts to resell the home, and because employees tend to question whether the amount paid by the employer is full fair market value, organizations developed alternative program structures. In these, the employee is allowed or encouraged or required to test the market by seeking an outside buyer prior to sale of the home to the employer.

Once a buyer is found, the employee sells the home to the employer at a price determined by reference to the outside offer. The employer then attempts to contract with the outside buyer, and sell the home to that buyer. The most common programs are the assigned sale, the amended value option, and the buyer value option (BVO).

Following is a general description of each. Note that the details of such programs, which may have a significant effect on their tax treatment, vary. Worldwide ERC® members seeking to implement one of these programs are advised to consult their own tax advisors.

Assigned sale program. The employer or RMC appraises the employee's home and offers the appraised value. The employee markets the home (usually for 60 to 90 days) with the assistance of a real estate broker.

If a higher offer is received, the employee accepts the offer by signing a sales contract. The employee then sells the home to the employer for the amount in the outside offer, and assigns the outside contract to the employer for completion.

The assigned sale program is rarely used—and should not be used—because the costs incurred are taxable to the employee.

Amended value option program. The procedures are similar to an assigned sale, but with differences that are crucial from a tax standpoint. The employee includes an "exclusion clause" in the listing agreement with the real estate broker, under which the broker does not earn a commission until a sale is closed, and earns no commission if the home is sold to the employer.

When an outside offer is received, the employee does not accept a down payment or sign the offer, but turns it over to the employer for approval. If the employer considers the offer bona fide, the employer amends its earlier offer to the employee to reflect the higher outside contract price, buys the home from the employee, signs its own listing agreement with a broker, and then attempts to enter into its own contract of sale with the outside buyer.

Buyer value option program (BVO). The procedures are the same as the amended value transaction, except that the employer does not appraise the employee's home or make an initial guaranteed buy-out offer.

Instead, the employer's offer is made only after the employee has marketed the home (including an exclusion clause in the broker listing agreement) and found a buyer. Thereafter, the procedures are the same as those followed in an amended value transaction.

If the employee does not find a buyer, procedures vary, but the program most likely to be respected by the tax authorities would include a provision for a guaranteed buy out at that point.

IRS Position

Numerous IRS private letter rulings dating to the early 1980s addressed assigned sale and amended value programs—or variations of them—with confusing, and sometimes contradictory, results.

In 1985, Worldwide ERC® published the "Eleven Key Elements and Procedures of an Amended Value Option," developed by its Law and Government Relations Committee (now the Coalition Public Policy Committee) and designed to provide the best case for non-taxability of expenses in the event of IRS challenge.

Until release of Rev. Rul. 2005-74, there was, however, no authoritative, published IRS position on any of these programs. In that ruling, IRS accepted for the first time not only appraised value programs structured according to Worldwide ERC® guidelines, but also amended value programs based on the 11 key elements. Publication of the ruling undoubtedly will go far to remove much of the uncertainty surrounding these programs that had been generated by the lack of an official IRS position, and by the *Amdahl* case, discussed below. Note that although the new ruling does not address assigned sales, IRS always has considered such programs to be taxable, and continues to do so.

The Amdahl Case

Since 1997, the tax treatment of home purchase programs has been confused further by the decision of the Tax Court in *Amdahl v. Commissioner.* In that case, the issue was not taxability of the costs to the employees. Rather, it was whether the employer got an ordinary business expense deduction for the costs incurred, or instead was required to treat all the costs as contributing to a capital loss on sale of the home, deductible only against capital gains.

Since it published Rev. Rul. 82-204 in 1982, IRS has taken the position that most costs incurred by the employer in buying and selling the employee's home are capital, but *Amdahl* was the first court test of that position. The program at issue involved both appraised value and assigned sale purchases.

Unfortunately, the employer in that case argued not only that the homes were not capital assets, but that alternatively, neither it nor the RMCs it employed ever actually owned the homes. That is, it owned no asset—capital or otherwise—but merely assisted the employees to make their own sales. This argument, if accepted, leads to the result that all costs are taxable income to the employees. But, as noted, neither the income tax treatment of the employees, nor the employment tax liability of the employer were at issue.

The court accepted the employer's alternative argument, based in part on factors not common in most home purchase programs today but in large part on factors present in all programs. As a result, IRS employment tax division agents have been conducting tax audits in which they are seeking to collect back withholding and payroll taxes on all relocation home purchase costs regardless of the type of program, citing the *Amdahl* case. In particular, IRS agents have asserted that use of a "blank deed" process to transfer title to the outside buyer is inconsistent with ownership of the home by the employer or RMC, a factor also relied on by the court in *Amdahl*.

In the blank deed process, the company never takes title, but obtains from the employee a deed with the buyer's name left blank, which it completes with the outside buyer's name when settlement is reached with the buyer. This process has been used to simplify the transactions and to avoid one set of state transfer taxes or recording fees (on the first sale).

In recent years, IRS agents increasingly have scrutinized other aspects of home purchase programs and argued that such facts as brief holding periods and limited risk exposure mean that the sale to the employer should be ignored and the employee should be treated as the real seller to the ultimate buyer. In 2004, the IRS Large and Midsize Business Division in Dallas, TX, completed and circulated for comment a draft of a Coordinated Issue Paper (CIP) on the issue. A CIP is a mechanism used by IRS to formalize and articulate its audit position on a particular issue. If it becomes final, agents are required to follow it and assert the issue in all audits.

The draft CIP contains numerous misunderstandings and mischaracterizations of the transactions involved, and Worldwide ERC® submitted extensive comments, which are available at *www.WorldwideERC.org.* The draft CIP agrees that regular, appraised value transactions, even with a blank deed, are not taxable, but says that both assigned sales and amended value transactions (and, by extension, BVO transactions) are taxable. Although the paper is a draft, it was widely followed by IRS agents.

In July 2001—based primarily on the ongoing audits—Worldwide ERC® recommended that companies cease using the blank deed process and begin taking title by deed in relocation home purchase transactions. A white paper discussing this recommendation was published on the Worldwide ERC® website, at *www.WorldwideERC.org/pdf/deed.pdf* (Adobe Acrobat reader required).

The ongoing uncertainty caused by *Amdahl* and the draft CIP was effectively ended by publication of Rev. Rul. 2005-74, which had been actively sought by Worldwide ERC® on behalf of the relocation industry.

Despite the ongoing audits based on *Amdahl*, and the draft CIP, the official position of IRS, as noted earlier, had never been clear and Worldwide ERC® began an initiative at the IRS National Office in 2002 to resolve the issue. Worldwide ERC® urged IRS to reject the *Amdahl* emphasis on the blank deed, and to issue at long last formal guidance concerning the elements it deems acceptable in relocation home purchase programs. Specifically, Worldwide ERC® asked IRS to formally bless procedures modeled on the 11 key element amended value transactions.

IRS responded with Rev. Rul. 2005-74. Rev. Rul. 2005-74 provides an unqualified endorsement of appraised value transactions, and of amended value transactions that conform to the 11 key elements crafted by Worldwide ERC® in 1985. The ruling says that two separate, independent sales occur in such transactions, and the holding in *Amdahl* will not apply. In both situations, the ruling makes clear that use of a blank deed does not affect the favorable result.

The ruling also provides a set of facts IRS considers not to result in two separate, independent sales, which will allow the industry, and IRS auditors, to focus on what IRS thinks are defects in home purchase programs, and correct them. The "bad" facts emphasized by IRS are that execution of the purchase contract from the employee is contingent on execution of the employer's contract with the outside buyer; that the employee retains the right to negotiate the employer's sale; and that the employee does not receive proceeds of sale until the employer's sale closes.

The ruling does not mention the BVO, either favorably or unfavorably. However, because the BVO is, in substance, simply an amended value transaction without an initial offer, the analysis of amended value transactions in the ruling would appear to apply to BVOs as well, with the result that BVOs conforming to the 11 key elements should continue to be considered nontaxable, and BVOs containing the unfavorable elements in the third factual scenario above will no doubt be treated as taxable by IRS.

Although a standard BVO should meet the requirements of the ruling, in practice IRS agents conducting audits since issuance of the ruling often have contended that a BVO is not covered and is taxable, since it is not specifically mentioned and lacks the appraisals and initial guaranteed buy-out offer characteristic of the amended value process. Employers should consider adding a delayed appraisal and guaranteed buy out to their BVO programs (for example, appraisals after 90 days of marketing, with a buy-out offer at 90 percent of the appraisals) to address this issue.

Issuance of the long-sought ruling eventually will bring needed certainty to the home purchase process. Nevertheless, employers with home purchase programs should expect IRS scrutiny of their programs and take steps to make sure they are properly structured and operated. Programs should, to the maximum extent possible, conform to those described favorably in Rev. Rul. 2005-74.

Home purchase programs are complex, with many considerations of both policy and tax compliance. This article is intended only as a general summary. Worldwide ERC® members conducting or considering such programs are advised to consult their own tax advisors.

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