Moving expenses

IMPACT OF RECENT RULINGS ON REIMBURSEMENT OF EMPLOYEE MOVING EXPENSES

Relocation of employees has been on the increase over the past decade, as companies recognize the need to maintain mobility of key employees. Such management-induced transfers serve a number of essential purposes, among which are the following:

Broadening of experience as part of the management development process.

Maximizing a desirable "cross-fertilization" effect within the organization.

Maintaining flexibility in manning new or growing operations and in utilizing talent made excess as a result of contracting operations.

Meeting the manning needs arising from mergers and acquisitions.

Facilitating reassignments made necessary by changes in organization structure or method.

Adjusting manpower resources to meet the demands of changes in technology, products, and markets.

Transfers to new locations involve, in many cases, difficult problems of readjustment for the employee and his family. To ease the financial hardship for employees involved in such moves, many employers have established policies that insure, in effect, that the employee is "made whole" in terms of the financial outlays. But recent Internal Revenue Service rulings and court decisions have created problems concerning reimbursement of moving expenses, including reimbursement of tax payments made by the employee, and have led many companies to re-examine their policy in this regard.

This report analyzes the background events leading to a definition of the current problems, reviews the current position of the companies surveyed, and outlines the considerations to be weighed in arriving at the necessary management decisions.

I. HOW THE PRESENT PROBLEMS AROSE

On June 14, 1965, the Internal Revenue Service issued Revenue Ruling 65-158 dealing with the obligation of employees to pay income taxes on the reimbursement of moving expenses.

IRS' ruling served a dual purpose. It was (1) a restatement of the Service's position on what moving expense payments are taxable as compensation and (2) a warning that vigorous enforcement of the regulations should be expected in the future by both employers and employees.

The nontaxable expenses payable to an employee who is being permanently transferred at employer request are of three kinds, according to IRS:

1. Transportation expenses for moving an existing employee and his family.

2. Transportation and certain related costs of moving the

personal and household effects of the employee and his family.

3. Expenses incurred for meals and lodging for an employee and his family while enroute to the new location.

All other reimbursements are considered taxable, including, for example, meals and lodging after arrival at the new location and while awaiting permanent quarters. The IRS has maintained this position for a number of years. However, the IRS position has not always met with full favor in the courts, and, on certain items, enforcement was largely held in abeyance. For example, a Tax Court ruling[1] that a loss suffered by an employee in the sale of a house could be reimbursed by the employer without constituting taxable income to the employee was widely recognized until legislative and judicial developments in recent years made this precedent no longer effective.

Two new developments which occurred in the past year and a half have contributed materially to the decision of IRS to launch its new enforcement efforts.

Congressional Action in 1964

Congress studied the subject of moving expense taxation in 1964 as part of its work of amending the Internal Revenue Act, but did not deal with the question of whether all expense items beyond the three approved categories are taxable as compensation. It took action only on a peripheral area of the moving expense question by giving tax assistance to two special

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[1] Otto S. Shairer, 9T.C. 549 (1947)

groups of employees—(1) "new" employees relocating in order to begin employment and (2) "old" employees not reimbursed by their employers for moving expenses that fell within the three approved categories. Although the two groups were given a deduction instead of an exclusion from gross income, the tax effect was essentially the same. In limiting this tax benefit to the three approved categories, Congress gave additional support to the Service's demarcation between taxable and nontaxable reimbursement.

The legislative reports on the 1964 amendments contained a significant statement which left to "judicial interpretation" the issue as to whether IRS had been unduly restrictive in making taxable for transferred employees reimbursement for all items beyond the approved categories. The result was to give more-than-usual weight to future court precedents on the subject.

The England Case

In England v. U.S., decided April 29, 1965, the Seventh Circuit Court directed an employee to pay an income tax on reimbursement for meals and lodging at the new location while awaiting permanent housing and for a trip made by his wife at company expense to inspect a house. The implication is that, in general, IRS' position will prevail in the future. Shortly after this clear-cut victory, IRS issued Ruling 65-158, creating concern within many companies as to whether their existing company policies and procedures on moving expenses are now suitable and, if changes are needed to insure compliance with IRS regulations, what should these be.

II. POLICY CONSIDERATIONS

The newly-supported IRS position poses alternative courses of action to employers:

1. In effect ignore the new regulations and accept the sizable risks involved.
2. De-liberalize the moving expense policy.
3. By various methods, accept the extra cost of reimbursing the employee for all or a major portion of the extra taxes incurred.

Twenty companies were surveyed by Industrial Relations Counselors, Inc., to determine current policy and practice on the matters dealt with in Revenue Ruling 65-158. The principal questions were two: (1) What is your company policy with respect to withholding income taxes on reimbursement of moving expenses? (2) Does your company reimburse employees for the income taxes withheld?

Survey Findings

On the First Question. Twelve companies reported that they do withhold taxes with respect to those items of reimbursement which IRS has declared taxable income. Three companies said they expected to begin withholding taxes on these items shortly, as soon as authorization within the company had been established. Three reported that they were not withholding and did not have plans to do so. Two companies were still undecided on what course to take.

On the Second Question. Ten companies reported that they reimbursed the employee for the tax withheld and two said they expected to begin this practice soon. Four companies said they did not make tax reimbursements, and expressed disagreement either with the concept of tax reimbursement, or with the IRS requirement to withhold taxes. Four others said they were still undecided as to whether they should reimburse the employee for taxes withheld.

Of the ten companies that reimburse the employee for the tax withheld, two reported that they also reimburse him for the tax on the tax reimbursement. Four other companies described certain reimbursement procedures which would help to reimburse some employees even with respect to the tax on the tax, but this was not declared to be an express objective of company policy in any of the four cases.

Company Policy and Practice

Many companies contend that the moving expenses challenged by IRS are reimbursements dictated by equity and sound personnel policy because they represent losses and costs incurred by the employee in order to comply with the company's request to transfer to a new location.

IRS' hostility to certain moving expense reimbursements is reported to stem in large part from tax abuses which have allegedly occurred in the payment of salesmen's bonuses—compensation disguised as reimbursement for expenses incurred in making permanent changes in station. Yet the written policies of many companies include specific limitations to guard against abuses. For example, one company limits the incidental moving expenses (servicing appliances, refitting rugs and draperies, disconnecting and connecting utilities) to 2 percent of annual salary, and limits the reimbursement of expenses incurred in the sale of the employee's house to 4 percent of annual salary.

Although most companies are complying with IRS tax rulings, the companies surveyed gave no indication of plans to cut back either the number or the extent of its expense reimbursements as the result of IRS' restrictive regulations, but rather are likely to add an item or two to the list of reimbursements in order to "make the employee whole." The reason for increased liberality is the same as it has been in the past, to decrease employee resistance to relocating and to accomplish it more quickly and more effectively in the company's interests. The real question is how far should a company go in removing the financial burden in order to compare favorably with competitors, and to achieve its long-range industrial relations goals. The legitimacy of these company purposes has long been recognized in industrial relations practice, including the agencies of government engaging in military procurement. For example, the Department of Defense's Armed Services Procurement Regulations make it clear that certain reimbursements that are not on IRS' approved list will be assumed by government agencies as part of the cost of articles purchased. These "extra" items include trips by the wife to inspect housing and temporary lodging while awaiting permanent quarters at the new location.

One company describes its present involvement in moving expense reimbursement in this way. It figures that the particular items it reimburses which lie beyond the IRS approved list constitute 50 percent of its outlay in this area and that these extra items impose a tax of $450, on the average, on an employee earning $10,000. Companies in this position are likely to consider the new tax requirements as materially lessening the effectiveness of the moving expense reimbursement policy unless they reimburse the employee for the tax.

Although the trend is to increase the extent of company involvement, in one respect companies are moving in the other direction. There is growing reluctance on the part of many companies to buy the employee's old home, and instead to reimburse employees for losses and costs incurred in liquidating the former residence. Such reimbursement is considered by at least one company to be not extra compensation, but the restoration to the employee of capital losses occasioned by a transfer requested by the company to serve its objectives. Also, company policy on this item of expense is likely to specify limitations on the amount of payment in order to prevent excessive reimbursement. One company, for example, limits its makeup of the loss on the former home to 10 percent of its appraised value.

Tax Implications

Another important area for policy consideration consists of weighing the various hazards involved in a company challenge to the IRS position. For example, some companies are willing to risk court litigation in order to resist what they consider an unwise ruling. Others may resist because company withholding constitutes implied agreement with the tax ruling, as IRS has contended in some court litigation. But most companies feel that, because of the risks, they have no real alternative except to withhold taxes on reimbursements as requested by IRS. For example, a failure to withhold may lead to a penalty assessment against the company by IRS. Also, it may dispose the Internal Revenue Service to assert tax liability within the particular company against employees who were transferred from one location to another in 1962, 1963, and 1964, and who might otherwise have escaped challenge with the passage of time. If the issue with IRS should become joined, the IRS can be expected to insist on payment for those years on the ground that it has consistently held taxable the reimbursement of these "compensation" items—including the makeup of losses on the home or of special living expenses—at least as long ago as 1954, in Revenue Ruling 54-429. Its position has been reinforced more recently by greater receptivity to IRS' position in certain federal courts, largely as a result of the England case.

This is important from a policy point of view. In the past, some company tax executives felt that there existed enough hostility in the federal courts to IRS' demand for taxation of various moving expense reimbursements to encourage a refusal to withhold, as a calculated risk. However, fewer companies are now willing to take the risk in the face of the England decision and the vigorous enforcement which IRS has indicated it will now make. Although certiorari has been sought from the Supreme Court in the England case, the Court may not grant it and, in any case, the possibility of reversal is considered speculative.

Challenge by IRS may also pose a problem for the companies that decide, on a case-by-case basis, the question of what reimbursements to make beyond the "approved" categories. The absence of a standardized or regularized procedure raises at least a possibility that some reimbursements in the taxable category may be overlooked with respect to the withholding requirements. In this respect the policy of one company of asking all employees to notify the company's Tax Department of any challenges made to employees by IRS may help both company and employee to join forces in order to meet any test presented by IRS.

Some companies hold strongly to the view that the employer should not become involved in the income tax liability of the employee, either to give counsel or to make up the tax. The fact is that most companies would prefer not to make tax reimbursements as a matter of principle, on the ground that taxes constitute a statutory liability of the employee and are not a matter of company concern. Thus, even some of the companies that are motivated by personnel policy considerations to withhold taxes and reimburse the employee, have nevertheless described it as unpalatable or inconsistent with the spirit of the tax requirements in general.

The remedy, as some companies see it, lies in the area of legislative reform, although they recognize that such changes will not come in the near future and will not be retroactive.

III. ADMINISTRATIVE CONSIDERATIONS

Some of the companies surveyed have described the method established for handling the administrative problems involved in the tax requirements.

One important question is <u>when</u> should withholding begin within a company, assuming the company has decided to go that route. The answer varies among companies, depending upon the date on which compliance can be reasonably expected by IRS. Some companies consider that the "new rules" became established in mid-1965 and that withholding should begin reasonably soon thereafter, that is, during the calendar year. Some companies plan to disregard moving expense reimbursements made before the June ruling of IRS. Others consider it necessary to engage in withholding now for moving expenses paid earlier in the year. Still others plan to begin the new practice on January 1, 1966.

A wide range of methods is possible with respect to the accounting procedures established within companies for reimbursement and withholding.

One company considers appropriate the addition of 20 percent to the amount withheld, without inquiring whether the employee is in a higher tax bracket. For some employees—those in the lower tax brackets—the amount thus paid in excess of the 14 percent required for meeting the withholding obligations under the statute may result in a reimbursement in whole or in part of the tax on the tax.

Another company makes a practice of adding 25 percent to the total of expenses reimbursed and then deducts a tax of 14 percent on the new total (amounting at that point to 125 percent). It then pays the employee the remaining 111 percent.

A third company deducts the 14 percent withholding tax, but then adds 14 percent to the reimbursement it makes to the employee. Later, when the employee submits proof of his tax bracket, the company pays him the difference between the tax he actually paid and the allowance of 14 percent previously given him, plus 14 percent of the extra payment "to make him whole."

Overall, the trend seems to be in the direction of reimbursement of the tax, although the methods by which this objective is achieved vary. The two examples on the following pages show the actual reimbursement formulas used in two instances.

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EXAMPLE A

SAMPLE METHOD OF COMPUTING WITHOLDING TAX ON REIMBURSED MOVING EXPENSES

Item		Amount
1. Reimbursed expenses subject to tax:		
Loss on sale of house	$2,000	
Expenses in finding new home	500	
Living expenses for employee and family while awaiting new quarters	1,000	
	$3,500	$3,500
2. Reimbursed expenses not subject to tax:		
Moving household goods and personal effects	$1,000	
Traveling expenses for employee and family in transit	500	
	$1,500	1,500
Total reimbursed expenses		$5,000
Less item 2 above		1,500
Total reimbursed expenses subject to tax		$3,500
Company allowance for makeup of state (5%) and federal (25%) taxes (30% x $3,500) ...		1,050
Total		$4,550
Tax withheld (14% of $4,550)		637

EXAMPLE B

EXAMPLE OF EFFECT ON EMPLOYEE INCOME OF TAXABLE REIMBURSEMENT FOR MOVING EXPENSES

Item	Example 1— Excluding Taxable Reimbursement	Example 1— Including Taxable Reimbursement	Example 3— Including Taxable Reimbursement Plus Tax Makeup
Base salary	$10,800.00	$10,800.00	$10,800.00
Reimbursement for moving expenses	..	2,320.00	2,320.00
Reimbursement for tax makeup on moving expense reimbursement[a]	..	..	815.14
Total company income	$10,800.00	$13,120.00	$13,935.14
10% deduction (maximum—$1,000)	1,000.00	1,000.00	1,000.00
	$ 9,800.00	$12,120.00	$12,935.14
Exemptions (husband, wife and 1 child)	1,800.00	1,800.00	1,800.00
Income subject to tax	$ 8,000.00	$10,320.00	$11,135.14
Federal income tax (1965 rates)	1,380.00	1,890.40	2,069.73
State income tax (assumed 4% rate)	320.00	412.80	445.41
Total federal and state taxes	$ 1,700.00	$ 2,303.20	$ 2,515.14
Income after taxes	9,100.00	10,816.80	11,420.00
Expenses paid out by employees	..	2,320.00	2,320.00
Net income	$ 9,100.00	$ 8,496.80	$ 9,100.00

[a] Tax Makeup Formula:

W = Amount required to make employee whole
M = Indirect, taxable moving expenses
R = Rate of combined Federal and State tax

$$W = \frac{M}{(1.00-R)}$$

Example

$$W = \frac{\$2,320}{(1.00-0.26)}$$

$$W = \underline{\$3,135.14}$$

Note: To determine an employee's tax rate the following is used:

1. Only income derived from Company
2. 10% standard deduction with maximum of $1,000
3. Actual personal and dependency exemptions.