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2008 Update: How to Avoid "Stealth Relocations" and the Potential Tax Consequences

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2008 Update:
How to Avoid "Stealth Relocations" and the Potential Tax Consequences

"In this world nothing can be said to be certain, except death and taxes."
Benjamin Franklin

Domestically and globally, the rapid growth of long-term "temporary" assignments (also known as "stealth relocations") currently pose complex challenges for mobility program managers. Long the norm for many companies and their employees, such as building contractors and management consultants, improper use of this relocation *alternative* may expose your organization to unexpected costs, tax implications and potential tax penalties.

Global HR News, a leading publication that focuses on global mobility policies, reports: "Today, temporary assignments are also being considered by companies for assignments that a few years ago might have been deemed permanent. Employees' demonstrated reluctance to move, and the high cost of those moves (according to ERC's 2007 transfer volume and cost survey, the average cost to move an existing employee home owner is $62,185 and $18,365 for a renter) is prompting some companies to also treat some longer-term job responsibilities as temporary in nature."

Peter Fonseca, CRP, Orion Mobility's Director of Operations, concurs, "Temporary assignments are not yet surpassing relocations, but the amount of temporary assignments that are taking place instead of relocations is increasing dramatically."

Fonseca attributes part of the rise to changing demographics: "The new focus is on Gen X & Gen Y. They're less likely to agree to move to a city that doesn't meet their lifestyle goals, unless it's put in terms of a temporary assignment. Also, two-career couples and Boomers with families are increasingly reluctant to pull up roots."

Fonseca adds, "Companies are offering more temporary assignments, versus relocations, to attract the top talent and using payback agreements to retain them. Even engineering and pharmaceutical companies that used to do a lot of relocations are doing more extended business trips of just under one year in length."

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NEW PROPOSED RULES, NEW APPROACHES TO COMPLIANCE

What are the limitations and often unforeseen tax implications of temporary assignments? How *do* companies manage compliance, and HR issues fairly, without overspending on gross-ups? With workforces that are more mobile and flexible than ever, it's essential to have specific policies in place and, in most cases, professional guidance.

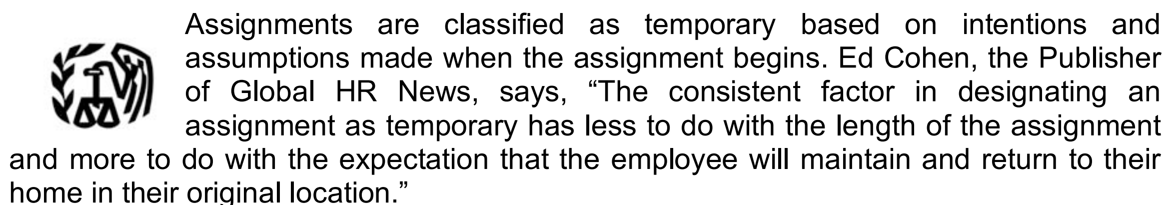
These issues were the hottest topics at Orion Mobility's 20th Anniversary Conference, held in Chicago this past September. David S. Oltman, CRP, Orion Co-Founder and President reported, "Compliance is still very much on corporate America's mind. Everyone wants to hear what's being done by peers." "The law today is ambiguous and only selectively enforced," Oltman explains. "In theory, if you work one day in a state, you would owe taxes in that state."

A new bill proposed in the House of Representatives, HR 3359, The Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, introduced in Congress on August 3rd could provide much needed clarification to employers and relocation professionals.

The law proposes to limit state or local taxation of the compensation of any employee who performs duties in more than one state or locality to: (1) the state or locality of the employee's residence; and (2) the state or locality in which the employee is physically present performing duties for more than 60 days. According to Oltman, issues yet to be resolved by Congress include how to define a day, and how many days to allow.

> *In the meantime, companies must be aware of all the factors that affect compliance.*

HOW THE IRS DEFINES TEMPORARY ASSIGNMENTS



Assignments are classified as temporary based on intentions and assumptions made when the assignment begins. Ed Cohen, the Publisher of Global HR News, says, "The consistent factor in designating an assignment as temporary has less to do with the length of the assignment and more to do with the expectation that the employee will maintain and return to their home in their original location."

In fact, the IRS draws a distinction between "**Temporary assignments vs. indefinite assignments."** Companies that place employees on "temporary" assignments that last for more than 12 months should be aware of IRS Publication 463 which states:

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…. "If an assignment is indefinite, the location of the assignment becomes the new tax home to the employee and the employee may not deduct travel expenses while there. An assignment in a single job location is considered indefinite if it is realistically expected to last for more than one year, whether or not it actually lasts for more than one year."

…. "If the assignment is indefinite, the employee must include in his income any amounts he receives from his employer for living expenses, even if they are called travel allowances and the employee accounts to the employer for them."

Obviously, these distinctions make a big difference in tax liability and relocation policies. Oltman explains, "In relocation, you gross up **EXPENSES**. On temporary assignments, you gross up **SALARIES** that cause extra taxes – that's the new issue."

Qualified Moves / Business Trips – See Revenue Ruling 93-86 (11/24/93)
One-Year Temporary Employment Rule. If the intent of the assignment is less than one year, the reasonable expenses reimbursed will be considered "business expenses". If the intent is "as long as necessary" or over one year, the expenses will not be considered business and need to be reported on the W-2, hence taxable or excludable. If the intent changes from under one year to over one year, only those expenses incurred after the intent changes become taxable or excludable.

Employees on temporary assignments also face income tax ramifications of dual-state employment. Employees employed in the same state that they are residents, who never leave that state to perform services, have state income tax withholding and income reporting that is quite simple. This is not the case when a company sends employees to other states to perform services on its behalf.

Some states have reciprocal personal income tax agreements with one or more states, including the District of Columbia, that allow income to be taxed in the state of residence even though it is earned in the other state. If there is no such reciprocal agreement between the two states, the employee usually files tax returns in both.

A Resident Tax Return would be filed for the state in which the employee maintains a residence, and a Nonresident Tax Return would be filed for the state in which the employee worked. When dual returns are required, a credit is typically allowed on the employee's resident state income tax return for taxes paid to the other state.

Unfortunately, issues of non-compliance are common, usually caused by the employee's failure to file the non-resident return. Quentin Hormel, CRP, Orion Mobility's Director of Tax Compliance explains, "States and the IRS have red flags that uncover non-compliant or missing returns. Eventually, the employee will get a letter from the tax board stating that unpaid taxes and a penalty are owed. Because most audits are 2-3 years behind, the penalties can be severe."

"In many cases, the employee may come back to the company and say, 'You didn't tell me,'" Hormel notes. He urges companies to be pro-active and protect themselves and their employees by setting up clear rules in advance.

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POLICIES AND BENEFITS: A THREE-TIERED APPROACH

Temporary assignment programs are created to facilitate getting the right people where they're needed for the time they're needed. Companies must also create, implement and continually update new policies and new tools to keep pace.

Temporary assignment policies, of course, are dependent on the assignment duration, which is dependent on the reason for the assignment: training, career development, mergers, joint ventures, project work, etc. Training and career development assignments typically have clear start and end dates, and can be managed with reasonable assumptions.

However, as Cohen points out, "employees working to meld the cultures of two distinct organizations in merger and joint venture situations may have estimated completion dates, which are dependent on intangible successes. Similarly, project work may experience unforeseen delays or lead to add-on projects, also causing assignment completion dates to be only estimates. Indefinite assignment timeframes can impact the policy benefits, as well as their tax ramifications; therefore, it is necessary to have policies in place to make the assignments most cost-effective."

For example, companies may wish to establish a **three-tiered policy** for temporary assignments based on timeframes of up to six months, six months to one year, and greater than one year. These tiers coincide with typical housing lease options, as well as IRS regulations. In general, assignments of shorter duration receive fewer benefits, compared with those that extend beyond six months or one year.

Temporary assignment benefits may include: trips to investigate housing options, interim living while waiting for temporary living quarters to become available, trips for the employee to return home, en-route travel to the new location, car rental or transport of the employee's personal automobile, limited shipment of household goods, property management (including goods), income tax protection (including dual state tax issues), and income tax consulting.

Assignments lasting up to six months often include the employee only. Stays beyond six months may include the option for the family to accompany the employee. The length of the assignment determines not only who goes to the new location, but what goes as well. Combined, these factors help determine the type of lodging to be reimbursed in the assignment location.

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TAX PITFALLS AND CURRENT BEST PRACTICES

Determining whether an assignment is temporary or indefinite is the essential first step to compliance. The IRS actually describes various scenarios in which the employee's expectations regarding the job determine the "tax home". The employee (and company) must determine whether the assignment is temporary or indefinite when work starts. If an assignment or job is expected to last for one year or less, it is temporary unless there are facts and circumstances that indicate otherwise. An assignment or job that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

Since intention determines liability, establishing clear expectations and documenting assignments is an essential HR function that must be clearly followed to protect both the employee and the company.

Lodging expenses, as well as some other temporary assignment related expenses, may be reported as business expenses if IRS requirements are met. At a minimum, the IRS requires the employee to keep their residence in the original location, to substantiate the time, place, and business purpose of expenses, to substantiate expenses with receipts – unless they are less than or equal to the GSA per diems – and return to their home location within 12 months.

Temporary assignments that extend beyond 12 months are deemed permanent, and all expenses, from the point the extension became known, are taxable income to the employee. If a company elects to reimburse lodging and meal expenses as a lump-sum allowance to employees on assignments up to one year in duration, the company may deduct the allowance as a travel expense on the company's tax return if it does not exceed the government per diem rate. However, the company would limit the expense by calculating 40% of the per diem as an allowance for meals, which is subject to the 50% deduction.

The amount of an allowance that is greater than the federal rate must be included on employees' W-2's, and is subject to income tax withholding, social security, Medicare, and federal unemployment taxes. The employer must include the amount as compensation (not as a travel expense) on the company's tax return.

The employee MUST file tax returns in BOTH their "live state" and their "temporary assignment work state". Most companies advance their employees on temporary assignment extra tax dollars to cover the additional state withholding requirements. At the end of the year a "reconciliation" is performed comparing how much money the employee actually paid in state taxes versus what the employee "would have paid" had they not taken the temporary assignment.

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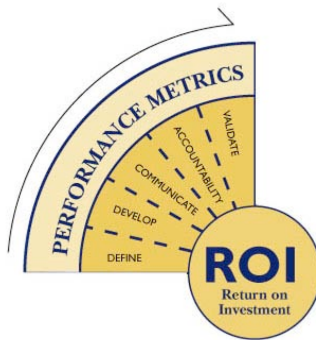
> Note: Many employers engage a professional tax preparation firm with multi-state taxation expertise to handle the reconciliation and or perform the gross-up audit.

Lump-sum allowances that include expenses beyond lodging and meals, such as car rental, eliminate the ability for the company to treat these other expenses as travel expenses. The employer must include the allowance amount up to the federal rate for lodging, meals and incidentals on employees' W-2's. This portion of the allowance the employer may deduct as a travel expense on the company's tax return; however, the remaining amount of the allowance must be included on employees' W-2's as compensation. The employee may deduct the other expenses as job expenses on his/her tax return, as long as the employee is able to substantiate the amounts.

FINE-TUNING GROSS-UPS FOR COST CONTROL.

Orion's Fonseca points out another essential – education and technology. He says, "Companies are realizing that for years their gross-up policies have been too generous."



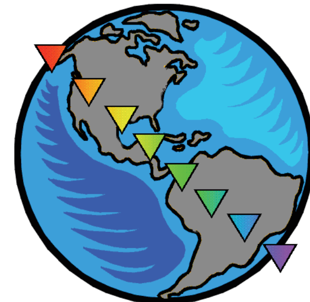
For example, some companies used the standard deduction because their technology/software couldn't handle complex itemization. Now, with software like Orion's reloviews® and other relocation accounting programs, companies can get exact numbers on each individual's tax impact.

"It goes beyond the software," Fonseca notes. "You need to have the expertise to teach the user how to take advantage of all the cost-savings. You need the software to provide the scenarios to save money and keep the employee whole, but you also need training and support."

He explains, "That's why companies are paying so much more attention to this issue when choosing a supplier. You have to start right, tax code the expenses properly when they come in, and interface into each company's payroll systems. Technology and the end user both play a vital role."

INTERNATIONAL ISSUES AND TAX IMPLICATIONS

Before companies send employees on temporary assignments internationally, they must consider not just immigration issues and work permits, but also complex tax issues. *Rather than containing costs, companies may incur penalties and unexpected tax consequences that erase any anticipated savings versus relocation.* If employees are away from their home country for less than 12 months, they usually will not break tax residency. Meanwhile, presence in a foreign country for more than thirty days may lead to tax liabilities unless there is a tax treaty between the two countries and all conditions are met. This brief example illustrates the importance of working with global relocation and tax management professionals prior to assigning employees to work in foreign countries.



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CONCLUSION: KNOW BEFORE THEY GO

Clearly it is always advantageous for a company to know the facts prior to placing employees on temporary assignments. Companies have always given consideration to federal and state tax laws when establishing policies, but have given less consideration to the quality of the reimbursements. As temporary assignments evolve within organizations, many are looking to manage them in a "hands-on" way, by establishing reimbursements based on cost surveys customized to their assignment needs, particularly with regard to lodging. The goal in managing temporary assignments is to quickly make employees fully productive in a cost-efficient manner, while keeping them in compliance with IRS regulations and keeping the program competitive at the same time.

Although we believe the tax discussion above to be substantively correct, Orion Mobility and Global HR News do not consider it to be definitive. We strongly advise you to seek your own tax counsel regarding the tax treatment of temporary assignment related expenses. For more information, see IRS Publication 463, or visit www.orionmobility.com or www.globalhrnews.com

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