

# Strasburger Tax Strategies

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**FOR MORE INFORMATION ON THIS TOPIC, PLEASE CONTACT:**



**James R. Browne**

Partner, Dallas  
901 Main Street, Suite 4400  
Dallas, Texas 75202.3794  
214.651.4420 Direct  
jim.browne@strasburger.com

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## IRS CLARIFIES TAX TREATMENT OF EMPLOYEE RELOCATION HOME SALE ASSISTANCE PLANS

The IRS recently published Revenue Ruling 2005-74 addressing the federal income tax consequences of home sale assistance plans commonly offered as part of employee relocation benefit programs. The ruling is believed to be a response to aggressive and improper efforts by IRS field agents to impute taxable compensation income to employees with respect to employee home sale assistance plans. The ruling should limit the circumstances in which compensation income will be imputed. It leaves in place, however, the IRS's position that employers recognize capital losses with respect to the expenses and losses incurred in such non-compensatory plans. Some employers take the position that the expenses and losses incurred in such plans are deductible as ordinary losses.

### BACKGROUND

When an employer relocates an existing or new employee, the employer may provide the employee with various relocation benefits to assist with the relocation. The benefits may include financial and other assistance with the sale of the employee's residence at the former location. The home sale assistance may be in the form of reimbursement of the expenses of selling the old residence (or terminating a lease). Alternatively, the employer may arrange for the purchase of the old residence from the employee at its appraised value, thereby relieving the employee of not only the expenses of selling the home, but also the distractions of listing and selling the house and the potential loss from a sale below fair market value. Such home purchase plans frequently are effected by the employer using a relocation service company ("RSC") that either purchases the employee's house on behalf of the employer, or facilitates the sale of the house by the employee to a third-party buyer.

Two questions arise with respect to home sale assistance benefits:

- Does the employee have taxable compensation income with respect to the benefits provided by the employer?
- Is the employer entitled to deduct any expenses or loss incurred by the employer in providing the benefit?

### EMPLOYEE TAX TREATMENT – REVENUE RULING 2005-74

Revenue Ruling 2005-74 addresses the employee's federal income tax treatment of home sale assistance benefits under three scenarios (described below). Overall, it clarifies that the (1) employee does not recognize taxable compensation income when the employer purchases the employee's house at appraised value, and (2) the employee has taxable compensation income when the employer merely facilitates the sale by the employee to a third-party buyer.

#### *Situation 1 – Appraised Value Option*

In Situation 1, Employer engages an RSC to act as Employer's agent in purchase and selling relocating employees' homes. Employer agrees to pay all of RSC's

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expenses, including any losses incurred by RSC on purchasing and reselling employee homes, and Employer is entitled to any profit earned on the purchase and resale of any employee home. Employee, who is relocating to another job site, elects to participate in the program. Employee's house is appraised at \$500x, and RSC offers to purchase the house for that price. The offer remains open for 90 days. The offer is not conditioned on RSC's ability to resell the house, and Employee is relieved of all expenses and risks associated with the ownership of the house once the sale closes. Employee accepts the \$500x offer and executes a blank deed to RSC. Upon resale of the house, RSC will insert the name of the ultimate buyer in the deed from Employee.

In this situation, the IRS ruled that the Employee's sale of the house to RSC represents a sale of the house to Employer. Employee recognizes a selling price of \$500x. None of the \$500x constitutes compensation income to the Employee. Also, although not explicitly stated, it is implicit in the IRS's ruling that the Employee also does not recognize any compensation income with respect to the Employer's absorption of any real estate sales commissions or other expenses to sell the house to a third-party buyer.

The ruling also does not directly address the question whether Employer's resale of the house for less than 500x might be evidence that the appraised value offer exceeded fair market value such that Employee might be treated as having compensation income for the excess. The implication of the ruling is that provided the appraised value represents a good faith estimate of fair market value, a subsequent sale for less than appraised value will not affect Employee's tax treatment.

### **Situation 2 – Amended Value Option**

Situation 2 of the ruling is similar to Situation 1, except that the home purchase program includes an "amended value option" pursuant to which the Employee is allowed to list the house with a real estate broker approved by RSC prior to accepting the appraised value offer. If the employee receives a bona fide offer to purchase for more than appraised value, the offer is referred to RSC and RSC will amend its offer to match the third-party offer. In the example, Employee receives an offer from a third-party buyer for \$520x, and RSC matches the offer. Employee accepts the amended RSC offer and sells the house to RSC. RSC (on behalf of Employer) takes the risk of reselling the house to the identified third-party buyer or to another buyer. Employer has the risk of loss and opportunity for profit on any such resale of Employee's house. Again, Employee executes a blank deed, and RSC inserts the name of the eventual buyer upon resale of the house.

The IRS confirmed that the employee's tax consequences in this situation are the same as in Situation 1. The employee is treated as selling the house to Employer for \$520x, and none of this amount is treated as compensation income.

### **Situation 3 – Assigned Sale Option**

Situation 3 is the same as Situation 2, except that the amended value offer is contingent on the closing of the sale to the identified third-party buyer. As a result, the RSC does not take the risk of the reselling the house at the amended

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value because the RSC's purchase of the house from the employee occurs simultaneous with the RSC's sale of the house to the third-party buyer. As in Situations 1 and 2, title to the house passes directly from the employee to the third-party buyer.

The IRS ruled that Situation 3 is in substance a sale of the house by the employee directly to the third-party buyer. As a result, any expenses paid by the employer (directly or through RSC) with respect to the sale would constitute taxable compensation income to the employee.

### **Impact of the Ruling**

Assuming the employer can obtain a tax deduction for the expenses of the home sale assistance program (see discussion below), it is generally beneficial to avoid compensation income to employees. Revenue Ruling 2005-74 confirms that the key to ensuring that employees avoid taxable compensation income is making sure that the terms of the home purchase arrangement transfer sufficient benefits and burdens of the ownership of the home to the employer. In this regard, the Tax Court has previously ruled that a home sale assistance plan very similar to Situation 2 above did not constitute a purchase of the employee's home by the employer. *Amdahl v. Commissioner*, 108 T.C. 507 (1997). One critical element in that case was the employee's right to receive any profit on resale of the house at a price in excess of appraised value.

Careful structuring of the terms of the home sale assistance plan is required to achieve the intended tax results.

### **EMPLOYER'S TAX CONSEQUENCES**

Revenue Ruling 2005-74 does not address the employer's tax consequences with respect to the home sale transactions. It therefore leaves in place existing guidance addressing the issue.

In situations where the employer does not purchase the employee's house, and merely reimburses the employee's home sale expenses, it seems well established that the reimbursement is taxable compensation income to the employee, and deductible compensation expense to the employer. Based on Revenue Ruling 2005-74, the same result would seem to apply where the employer facilitates the employee's sale of his or her house and pays the costs associated with the employee's sale. The employer should get a compensation expense deduction for the costs incurred and included in the employee's taxable compensation income.

In situations where the employer does purchase the employee's former residence, the IRS position, based on Revenue Ruling 84-204, is that the employer's expenses of reselling the home are capitalized costs that generate capital loss (or reduce capital gain). Provided the employer has sufficient capital gains to absorb the capital losses, the employer's costs are effectively deductible.

The holding of Revenue Ruling 82-204 was implicitly validated in *Azar Nut Co. v. Commissioner*, 94 T.C. 455 (1990), *aff'd*, 931 F.2d 314 (5th Cir. 1991). The taxpayer in that case argued that a loss incurred on the purchase and resale of an

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employee's home pursuant to a severance agreement constituted an ordinary loss because the house was exempted from capital asset treatment under I.R.C. § 1221(a)(2) (which applies to real property used in a trade or business). The Tax Court held that the house was not used in the employer's trade or business, and stated without detailed analysis that the house "was property not within any of the statutory exceptions to the definition of a capital asset under section 1221."

Notwithstanding these precedents, some employers argue that employee homes purchased pursuant to employee home sale assistance plans represent inventory property excluded from capital asset treatment under I.R.C. § 1221(a)(1). The IRS will likely disagree with this position and argue that I.R.C. § 1221(a)(1) does not extend to employee homes purchased and resold under a home sale assistance plan. For small employers who rarely purchase and resell homes, the argument for ordinary loss treatment may be even more difficult to sustain.

## CONCLUSION

Revenue Ruling 2005-74 provides welcome guidance for employers on the employee tax consequences of home sale assistance benefits. It should be easier going forward to avoid unintended taxable compensation income to employees. However, programs must be carefully designed to ensure the intended tax consequences. In addition, there continues to be some uncertainty regarding the employer's tax consequences of non-compensatory home sale assistance plans.

Members of our *General Tax Planning Practice Group* are available to assist you with questions related to these issues. We can advise on the tax treatment of other employee relocation benefits, including excludible moving expense reimbursements and tax-favored interest-free relocation loans. ■

## TAXES, ESTATE PLANNING & EMPLOYEE BENEFITS CONTACTS:

### AUSTIN

JoAnn Dalrymple ..... 512.499.3614

### COLLIN COUNTY

Jason Forshee ..... 469.287.3914

Mike McClelland ..... 469.287.3919

**John Round**, Team Leader ... 469.287.3926

Dani Smith ..... 469.287.3918

### DALLAS

Luke Bailey ..... 214.651.4572

James Browne ..... 214.651.4420

Dan Butcher ..... 214.651.4640

Jack Dugan ..... 214.651.4608

Brad Fletcher ..... 214.651.4418

Drake Frazier ..... 214.651.4712

Jack Kinnebrew ..... 214.651.4613

Ashley Kisner ..... 214.651.4818

Toni Reed ..... 214.651.4345

### HOUSTON

Paula Denney ..... 713.951.5626

Betsy Kamin ..... 713.951.5635

### SAN ANTONIO

Farley Katz ..... 210.250.6007

Chad Muller ..... 210.250.6003

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