Hughes v. Commissioner, 65 T. C. 566 (1975)

Moving expenses must be allocated between taxable and tax-exempt income when the income earned at the new employment location is partially exempt from taxation.

Summary

William Hughes, employed by Sea-Land Service, Inc. , was transferred to Spain and claimed a moving expense deduction under section 217. The IRS argued that the expenses should be allocated between taxable and exempt income under section 911(a). The Tax Court held that moving expenses are not fully deductible if they are allocable to exempt income earned abroad, reversing its prior stance in Hartung and Markus. This decision impacts how moving expenses are treated for employees with foreign assignments and income exempt from U. S. taxation.

Facts

William Hughes was an employee of Sea-Land Service, Inc. , based in New Jersey. In 1971, he was temporarily assigned to work in Spain. He received a salary from both Sea-Land Service and its Spanish subsidiary, Sea-Land Iberica. Hughes claimed a moving expense deduction of $5,653 under section 217 for his move to Spain. He earned $30,533 in foreign income in 1971, of which $17,041. 10 was excluded from gross income under section 911(a). The IRS contended that the moving expenses should be allocated between taxable and exempt income.

Procedural History

The IRS determined a deficiency in Hughes's federal income tax for 1971, arguing that part of the moving expenses were allocable to exempt income. Hughes petitioned the U. S. Tax Court, which had previously allowed full deductions for moving expenses in similar cases (Hartung and Markus). However, those decisions were reversed on appeal by the Courts of Appeals for the Ninth and D. C. Circuits. The Tax Court, in this case, decided to follow the appellate courts' rulings and disallow a portion of the moving expense deduction.

Issue(s)

1. Whether moving expenses, otherwise deductible under section 217, must be allocated between taxable and tax-exempt income under section 911(a).
2. Whether the reimbursement of moving expenses constitutes earned income under section 911(b).
3. Whether the reimbursement represents foreign-source income under sections 861 and 862.
4. Whether moving expenses should be allocated under sections 861 and 862 or section 911.

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Holding

1. Yes, because moving expenses are closely related to the production of gross income and must be allocated between taxable and exempt income as per section 911(a).
2. Yes, because the reimbursement is attributable to personal services rendered at the new location and thus constitutes earned income under section 911(b).
3. Yes, because the reimbursement is attributable to services rendered in Spain and is therefore foreign-source income under section 862(a)(3).
4. No, because the moving expenses are properly allocable to the gross income earned at the foreign location and should be allocated under section 1. 911-2(d)(6) of the Income Tax Regulations.

Court's Reasoning

The Tax Court reasoned that moving expenses, which were previously considered nondeductible personal expenses, became deductible under section 217 when related to starting work at a new principal place of employment. The court concluded that these expenses are income-related and must be allocated between taxable and exempt income under section 911(a). The court overruled its prior decisions in Hartung and Markus, following the appellate courts' reversals, which emphasized that moving expenses are linked to the income earned at the new job location. The court also determined that the reimbursement for moving expenses was earned income under section 911(b) because it was compensation for services rendered in Spain, and thus foreign-source income under section 862(a)(3). The dissent argued that moving expenses should remain fully deductible as personal expenses, not subject to allocation under section 911(a).

Practical Implications

This decision impacts employees moving to foreign assignments with tax-exempt income under section 911(a). It requires that moving expenses be allocated between taxable and exempt income, potentially reducing the deduction for those with significant exempt income. Legal practitioners must now advise clients on the necessity of allocating moving expenses when part of the income from the new job is tax-exempt. This ruling also affects how businesses handle reimbursements for employees moving abroad, as it may influence decisions on when to move and whether to seek reimbursement. Subsequent cases like Rev. Rul. 75-84 have addressed the timing of moving expense deductions, but the principle of allocation remains a key consideration for tax planning involving foreign assignments.

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