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THE LOWDOWN ON GROSS-UP

How to rightsize your policy to fit company needs

By Martijn Bouwman

Julie was recruited to take on an executive role at a fast-growing startup, but it required her to relocate from Chicago to Cleveland. The company's recruiter considered Julie a "purple unicorn," which means a rare find, and offered her a generous salary of \$350,000 with a competitive relocation package of \$30,000. Julie and her family decided to transition to a smaller city because of this opportunity. In addition to being a boost to Julie's career, the move led to a larger house in a quiet suburb complete with an exceptional school district.

Months passed as Julie and her family settled in to their new community. After spending the holidays in the new home, Julie met with her accountant. Much to Julie's surprise, she owed more than \$11,000 in income tax.

"It's due to the reimbursements you received for your relocation expenses," the accountant explained. "It wasn't grossed up properly."

Julie was not expecting this financial liability and felt her company had overlooked a large detail in an otherwise well-planned relocation.

THE IMPACT OF GROSS-UP

In the U.S., Julie's scenario is not unique, and on the other end of the spectrum, some transferees are overpaid

and receive larger-than-expected tax refunds. Neither scenario is ideal. When transferees get a larger refund, they will be happy (although they may not recognize the reason for the increased payout), but it puts a lot of strain on the organization's global mobility budget.

What causes these differences? The gross-up policy. Setting a policy doesn't simply entail making a decision on whether to gross up or not—there are many other factors to consider, such as the gross-up rate and whether to gross up the gross-up. All these decisions impact the amount a transferee receives.

RIGHTSIZING THE GROSS-UP POLICY

If each transferee is impacted differently, what's the proper approach? Establishing the optimal gross-up policy means rightsizing it to fit your company's relocation program objectives, or better yet, the company's overall business objectives.

- A highly innovative technology company whose employees are its most important asset may err on the side of caution and establish a very generous gross-up policy to make sure the employees are not paying out of pocket and have a great relocation experience.
- A company that is struggling financially may need to focus more on cost and set a gross-up policy that fits within the global mobility budget.

BENEFITS OF RIGHTSIZING

Rightsizing entails a thorough review of your policy, your options, and the impact of your options. While it requires some investment, overlooking this exercise may be shortsighted.

- A properly structured policy can yield cost savings and/or improve the transferee experience.
- Securing gross-up funds becomes easier when proposed budgets are backed by data and sync with company objectives.
- Understanding how recent tax changes affect gross-up helps mobility teams avoid surprises and educate transferees.

START WITH THE GROSS-UP RATE

When defining the gross-up policy, one of the first decisions you need to make is what gross-up rate to apply. There are generally three options:

1. The *marginal rate* is based on the employee's actual tax status and takes into account such factors as the employee's filing status and gross income.
2. The *supplemental rate* is based on a set of standard withholding rates as determined by federal, state, and local governments.
3. The *flat rate* is one specific rate, set by the global mobility team, which is applied to all gross-up calculations.

FACTOR IN A CALCULATION METHOD

Whatever gross-up rate you choose, the gross-up payments are in turn taxable. It is therefore common to "gross up the gross-up" and mitigate the tax-on-tax exposure. There are generally two options:

1. The *inverse method* accounts for the additional tax liability the gross-up payment creates, i.e., the tax-on-tax exposure. The inverse rate formula is: Tax Rate / (1-Tax Rate) = Inverse Gross-Up Rate.
2. The *flat method* does not compensate for the tax-on-tax liability but just uses the marginal, supplemental, or flat tax rate to determine the gross-up amount.

How do the different rates and calculation methods impact the gross-up? The following scenarios illustrate the varying effects. While other factors, such as additional income or actual deductions, may impact calculations, we've made assumptions for the sake of simplicity.

SCENARIO CALCULATIONS

Scenario 1: Employee moves with family to Ohio. Tax filing status: married filing jointly (MFJ). Gross annual income: \$350,000. Moving expenses reimbursed by employer: \$30,000.

Gross-up amounts:

Marginal flat	\$11,804	Supplemental flat	\$8,355
Marginal inverse	\$19,462	Supplemental inverse	\$11,580

The marginal inverse rate (**\$19,461.60**) is the closest to the employee's actual tax liability because the calculation estimates their actual marginal tax bracket when filing their tax return. With a standard deduction of \$24,000, estimated taxable income without relocation is \$326,000, placing the transferee firmly in the 32 percent Federal bracket, 4.997 percent state bracket, and 2.35 percent for Medicare. The sum comes to 39.347 percent—total taxable (\$30,000 + \$19,461.60) multiplied by 39.347 percent equals total gross-up. Meanwhile, flat calculations do not gross up for the gross-up, and supplemental typically is a flat rate, such as 22 percent for Federal. How the marginal inverse compares:

- The employee would *owe* the tax authorities **\$4,645** by using the marginal flat rate.
- The employee would *owe* the tax authorities **\$6,737** by using the supplemental flat rate.
- The employee would *owe* the tax authorities **\$4,780** by using the supplemental inverse rate.

Scenario 2: Employee moves with family to Colorado. Tax filing status: MFJ. Gross annual income: \$70,000. Moving expenses reimbursed by employer: \$10,000.

Gross-up amounts:

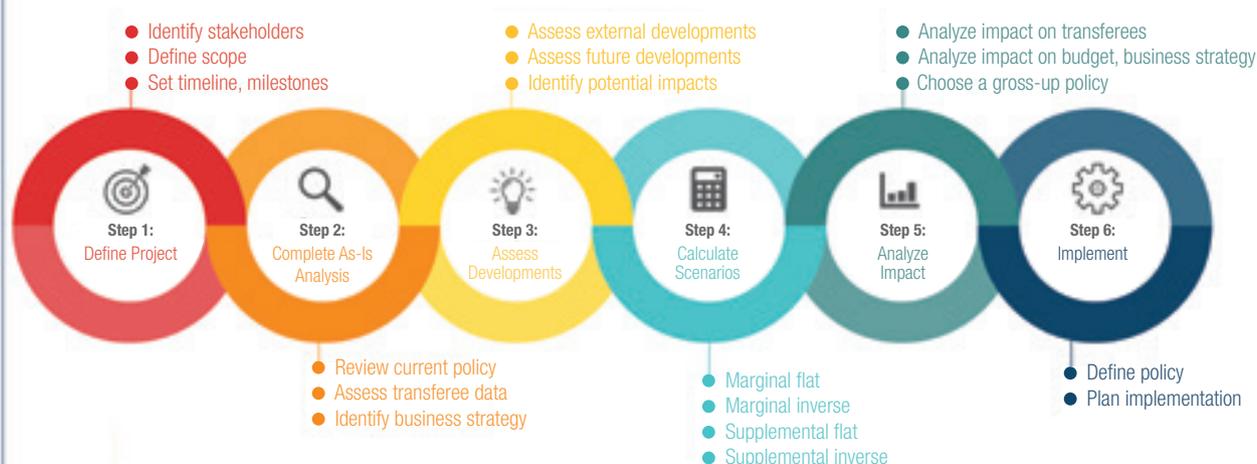
Marginal flat	\$2,428	Supplemental flat	\$3,428
Marginal inverse	\$3,207	Supplemental inverse	\$5,216

The marginal inverse rate (**\$3,207**) is the closest to the employee's actual tax liability because the calculation estimates their actual marginal tax bracket when filing their tax return. With a standard deduction of \$24,000, estimated taxable income without relocation is \$46,000, placing the transferee firmly in the 12 percent Federal bracket, 4.63 percent state bracket, 6.2 percent for OASDI, and 1.45 percent for Medicare. The sum comes to 24.28 percent—total taxable (\$10,000 + \$3,207) multiplied by 24.28 percent equals total gross-up. How the marginal inverse compares:

- The employee would *owe* the tax authorities **\$590** by using the marginal flat rate.
- You would *overpay* the employee **\$168** by using the supplemental flat rate.

Choosing a Gross-Up Policy

What's the best gross-up policy? The answer lies in your data. Follow this step-by-step approach to identify the optimal policy for your organization.



- You would *overpay* the employee **\$1,522** by using the supplemental inverse rate.

These examples show that a certain gross-up rate and calculation method can leave one transferee with thousands of dollars in additional tax liability, while another transferee is overpaid using that same gross-up rate and calculation. It is therefore very important to know the demographics of your transferee population and the impact the different rates have on your specific population.

CONDUCT A GROSS-UP REVIEW

When putting together a gross-up policy, you should start with a review of your current policy, transferee population, and external and future developments, and calculate the impact the different rates would have had on last year's relocations. The process shown in the chart above will help you choose the optimal policy for your company and employees.

LEVERAGE GROSS-UP SOFTWARE

To calculate the impact different rates have on your transferee population and your budget, it is ideal to use gross-up calculation software. This software will save you a lot of time and reduce the risk of mistakes. The best gross-up calculators continuously update their software to factor in changes to tax law. Federal changes are oftentimes well-published and generally have a big impact, but states in the U.S. are also continually updating and changing their tax laws.

TAP INTO CONSULTING

Time and competing priorities often inhibit mobility teams from thoroughly analyzing their gross-up policies. However, there are companies that will do the analysis via a consulting engagement. You will still need to dedicate time to the project, but most of the heavy lifting will be performed by the consultant.

CHANGE THE OUTCOME

If Julie's employer had rightsized its gross-up policy, she would have experienced a different outcome. The company would, too. They, like many employers, are often surprised by the impact of various gross-up strategies. With tax reform in place in the U.S., now is the time to understand and examine your options and implement a policy that best serves your transferees and your company. *M*

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